3 September 1998 A4-0299/98

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REPORT

on 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 (COM(98)0067 - C4-0195/98 - 98/0087(CNS))

Committee on Economic and Monetary Affairs and Industrial Policy

Rapporteur: Mr Carlo Secchi

Opinion Draftsman (*):

Ms Christine Oddy, Committee on Legal Affairs and Citizens' Rights

(* "HUGHES" Procedure)

C O N T E N T S

Page

Procedural page 3

A. LEGISLATIVE PROPOSAL 4

DRAFT LEGISLATIVE RESOLUTION 7

B. EXPLANATORY STATEMENT 8

Opinion of the Committee on Legal Affairs and Citizens' Rights (*) 10

(* "HUGHES" Procedure)

By letter of 31 March 1998 the Council consulted Parliament, pursuant to Article 100 of the EC Treaty, on 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.

At the sitting of 27 May 1998 the President of Parliament announced that he had referred this proposal to the Committee on Economic and Monetary Affairs and Industrial Policy as the committee responsible and the Committee on Legal Affairs and Citizens' Rights for its opinion.

At its meeting of 16 April 1998 the Committee on Economic and Monetary Affairs and Industrial Policy had appointed Mr Carlo Secchi rapporteur.

At the sitting of 19 June 1998, the President announced that this report would be drawn up according to the HUGHES procedure by the Committee on Economic and Monetary Affairs and Industrial Policy in conjunction with the Committee on Legal Affairs and Citizens' Rights.

It considered the Commission proposal and the draft report at its meetings of 25 May 1998 and 3 September 1998.

At the last meeting it adopted the draft legislative resolution unanimously.

The following were present for the vote: von Wogau, chairman; Katiforis and Garosci, vice-chairmen; Secchi, vice-chairman and rapporteur; Anttila (for Cox), Areitio Toledo, Barton (for Billingham), Berès, Blot (for Trizza), Bowe (for Caudron), Camisón Asensio (for Arroni), Carlsson, Cassidy (for de Brémond d'Ars), Castagnède, Christodoulou, Cunningham (for Glante), Donnelly, Ettl (for Kuckelkorn), Fayot, Fourçans, Friedrich, García Arias, García-Margallo y Marfil, Gasòliba i Böhm, Glase (for Konrad), Harrison, Hendrick, Herman, Hoppenstedt, Ilaskivi, Imbeni, Kestelijn-Sierens, Langen, Larive, de Lassus (for Scarbonchi), Lukas, E. Mann (for Murphy), T. Mann (for Lulling), Metten, Mezzaroma, Miller, Paasilinna, Peijs, Pérez Royo, Porto (for Mather), Rapkay, Read, Riis-Jørgensen, de Rose, Rübig, Skinner (for Randzio-Plath), Soltwedel-Schäfer, Thyssen, Willockx (for Torres Marques) and Wolf (for Hautala).

The opinion of the Committee on Legal Affairs and Citizens' Rights is attached.

The report was tabled on 3 September 1998.

The deadline for tabling amendments will be indicated in the draft agenda for the relevant part-session.

A
LEGISLATIVE PROPOSAL

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 (COM(98)0067 - C4-0195/98 - 98/0087(CNS))

The proposal is approved with the following amendments:

Text proposed by the Commission([1])	Amendments by Parliament
(Amendment 1) Recital 2a (new)	
	Whereas administrative formalities and cash flow problems are particularly relevant for Small and Medium-sized Enterprises, possibly limiting flexible intra-group financing arrangements while discouraging at the same time forms of cross-border co-operation;
(Amendment 2) Recital 4a (new)	
	Whereas it is important to extend the provisions of this Directive also to taxes levied on interest and royalty payments made between companies which are not associated, as part of the further development of the Single Market;

([1]) OJ C 123, 22.04.1998

(Amendment 3)
Recital 5a (new)

Whereas the synchronism in the legislative progress of the various elements of the package should be taken as a broad target to be achieved in the medium term, and shall not be used, on the contrary, as a tool by Member States to delay the approval of the various elements of the package;

(Amendment 4)
Article 6(2)

2. A Member State may withdraw the benefit of or refuse to apply this Directive in the case of any transaction which has as its principal objective or as one of its principal objectives tax evasion or tax avoidance.	2. A Member State may withdraw the benefit of or refuse to apply this Directive only in the case of a transaction which has as its principal objective tax evasion or tax avoidance.

(Amendment 5)
Article 7(2a) (new)

2a. Member States shall commit themselves to re-examine their existing laws and established practices, in line with the principles set out in the Code of Conduct for business taxation([1]), in order to guarantee a wide application of the provisions of the Directive by the time it enters into force.

[1] "Resolution of the Council and the representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation" , OJ vol.41, 6 January 1998, series C, page 2

(Amendment 6)
Article 10

Three years after the date referred to in Article 9(1), the Commission shall report to the Council on the operation of this Directive, in particular with a view to extending its coverage to companies or undertakings other than those covered by this Directive, and to reviewing the application of Article 7.	Three years after the date referred to in Article 9(1), the Commission shall report to the Council on the operation of this Directive, in particular with a view to extending its coverage to companies or undertakings other than those covered by this Directive, to eliminating the exceptions granted as of Article 7 and to ensuring the consistency of this Directive with the other elements of the tax package([1]) implemented by the Commission.

[1] "Conclusions of the ECOFIN Council meeting on 1 December 1997 concerning taxation policy", OJ vol.41, 6 January 1998, series C, page 1 and
"A package to tackle harmful tax competition in the European Union", 5 November 1997, COM(97)564

DRAFT LEGISLATIVE RESOLUTION

Legislative resolution embodying Parliament's opinion on 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 (COM(98)0067 - C4-0195/98 - 98/0087(CNS))

(Consultation procedure: first reading)

The European Parliament,

- having regard to the Commission proposal to the Council, COM(98)0067 - 98/0087(CNS)([1]),

- having been consulted by the Council pursuant to Article 100 of the EC Treaty (C4-0195/98),

- having regard to Rule 58 of its Rules of Procedure,

- having regard to the report of the Committee on Economic and Monetary Affairs and Industrial Policy and the opinion of the Committee on Legal Affairs and Citizens' Rights (A4-0299/98),

1. Approves the Commission proposal, subject to Parliament's amendments;

2. Calls on the Commission to alter its proposal accordingly, pursuant to Article 189a(2) of the EC Treaty;

3. Calls on the Council to notify Parliament should it intend to depart from the text approved by Parliament;

4. Asks to be consulted again should the Council intend to make substantial modifications to the Commission proposal;

5. Instructs its President to forward this opinion to the Council and Commission.

([1]) OJ C 123, 22.04.1998

B
EXPLANATORY STATEMENT

In implementing the "package" of measures for fighting harmful tax competition proposed by the Commission([1]) and endorsed([2]) in its entirety by the ECOFIN Council of 1st December 1997, the European Commission has put forward the 4th March 1998 a proposal for a Directive (COM(98)67) to eliminate withholding taxes on payments of interest and royalties between associated companies of different Member States. The legal base for the proposal is Article 100 of the European Community Treaty. It must therefore be adopted unanimously by the Council, after consulting the European Parliament and the Economic and Social Committee.

In the document it is clearly showed how taxes levied at source, either by deduction (i.e. withholding taxes) or by assessment, in Member States on interest and royalties paid to companies resident in other Member States can create problems for companies engaged in cross-border business. In particular, such taxes can involve time-consuming formalities, result in cash flow losses and sometimes lead to double taxation, thus creating a significant tax handicap to companies' cross-border operations within the Single Market. The effect are likely to be particularly detrimental for SMEs engaged in cross-border activities. As a result, the Commission proposed that interest and royalty payments should be taxed in the Member States where the companies which receive the payments are located.

The proposed Directive is designed to relieve double taxation but not to facilitate non-taxation. The proposal therefore includes provisions to ensure that Member States are not precluded from taking steps to combat fraud or abuse. Such steps could include denying companies the benefits of the Directive. However, it is the opinion of your Rapporteur that the use of such an exception in the application of this Directive can be justified only in the case of a transaction which has as its principal and sole objective tax evasion or tax avoidance.

Member States would also be allowed not to apply the exemption from source country taxation if the beneficiary of the payments qualified for a special tax rate on those payments which was lower than the rate normally applied to such payments in the Member State where it was established. This disposition is contrary to the spirit and the substance of the Code of Conduct of business taxation recently approved by the Ecofin Council, although it is currently necessary given the present situation in the field of business taxation. As a result, it is the opinion of your Rapporteur that the exception set out in Article 7 of the proposed Directive should be gradually phased out, together with a parallel implementation of the provisions of the Code of Conduct.

In order to alleviate the budgetary impact of the interest and royalties proposal on Greece and Portugal, which are net importers of capital and technology, these Member States would be allowed to retain a withholding tax during a transitional period. They could apply a withholding tax of 10% during the first two years and 5% during the following three years following the entry into force of the Directive.

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[1] "A package to tackle harmful tax competition in the European Union", 5 November 1997, COM(97)564

[2] "Conclusions of the ECOFIN Council meeting on 1 December 1997 concerning taxation policy", OJ vol.41, 6 January 1998, series C, page 1

The Commission would report on the operation of this Directive three years after it entered into force, with a view to a possible extension of its scope. This review would also allow a re-examination of the option given to Member States not to apply the Directive to payments which benefited from a special low tax rate, particularly in the light of progress on the code of conduct for business taxation, as already stated.

In addition, this review should be accompanied by a general judgement on the state of implementation of the different provisions embedded in the package to tackle harmful tax competition (a Code of Conduct for business taxation, a European solution in the area of taxation of income from savings and measures to eliminate withholding taxes on cross-border interest and royalty payments between companies), recently put forward by the Commission and approved in its entirety by the Council and the European Parliament.

Last but not least, the process of adoption of this Directive, as part of a more comprehensive package envisaged to fight harmful tax competition, shall not be used as a tool by Member States to delay the approval of the various elements of the package, invoking an exact synchronism in the implementation of the different legislative provisions. In fact, the complete implementation of the different proposals of the package should be taken as a broad target to be achieved in the medium term.

EUROPEAN PARLIAMENT

23 July 1998

OPINION
(Rule 147 of the Rules of Procedure)

for the Committee on Economic and Monetary Affairs and Industrial Policy

on the Commission 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 (COM(98)0067 - C4-0195/98 - 98/0087(CNS))
(Rapporteur: Mr. Secchi)

Committee on Legal Affairs and Citizens' Rights

Draftsperson: Ms Christine Oddy

PROCEDURE

At its meeting of 15 April 1998 the Committee on Legal Affairs and Citizens' Rights appointed Ms Oddy draftsperson.

It considered the draft opinion at its meetings of 29 and 30 June 1998 and 23 July 1998.

At the last meeting it adopted the following conclusions unanimously.

The following were present for the vote: De Clercq, chairman; Palacio Vallelersundi, vice-chairman; Rothley, vice-chairman and acting draftsperson; Berger, C. Casini, Cassidy, Ewing, Fontaine, Gebhardt, Lehne, D. Martin, McIntosh, Mosiek-Urbahn, Thors and Wijsenbeek.

1. The reasons for the proposal

Tax law is almost exclusively a competence of the Member States. National tax laws usually differ significantly from each other. The traditional method for tempering the main adverse effects of such differing laws is the application of bilateral tax treaties. Such tax treaties normally follow the OECD

Model Tax Convention on Income and on Capital.([1]) However, the coordination achieved with such instruments shows some lacunae and many exceptions are permitted.

It is obvious that a higher degree of harmonization in the field of taxation would contribute to a smoother operation of the internal market and facilitate the carrying out of transfrontier business. The Commission´s proposal therefore appears to be justified.

2. Legal base and political context

(a) Community competences in fiscal matters are rare. Article 99 EC-Treaty is applicable only to indirect taxation. Article 100a (2) explicitly excludes its application to fiscal provisions. Article 100 thus remains the only appropriate legal base for the present proposal. It requires *unanimity* in the Council.

(b) With a view to tackling tax competition and tax distortion issues, the Commission has proposed on 4 March 1998 a Directive aimed at eliminating double taxation with regard to *interest* and *royalty* payments (to be discussed in this opinion) and on 20 May 1998([2]) it proposed a Directive in the field of *savings income*. The latter proposal is aimed at the elimination of *non*-taxation of income.([3])

As the text of the savings income proposal has not yet been forwarded to Parliament, possible ***interactions between the two proposals*** will not and cannot be examined in the following opinion. However, examination of this interaction should be carried out during the legislative proceedings concerning the proposal.

(c) Both proposals have been preceded by various similar legislative initiatives, albeit without success.([4])

(d) It is useful to mention the Conclusions of the Ecofin Council Meeting on 1 December 1997 concerning taxation policy([5]) and the Council Conclusions of 9 March 1998 concerning the establishment of the (confidential([6])) Code of Conduct Group (business taxation).([7])

3. How the proposal would operate in general

The following example required some simplification.

([1]) OECD Committee on Fiscal Affairs, OECD, Paris, updated as of 1 March 1994; Model Tax Convention on Income and on Capital, abridged version, September 1996.
([2]) OJ C 212, 8.7.1998, p. 13.
([3]) Article 1.
([4]) COM(90)571 (OJ C 53, 28.2.1991, p. 26); COM(79)737 (OJ C 21, 26.1.1980, p. 6); COM(89)60 (OJ C 141, 7.6.1989, p. 7).
([5]) OJ C 2, 6.1.1998, p. 1.
([6]) See conclusion 13.
([7]) OJ C 99, 1.4.1998, p. 1.

Suppose X and Y are associated companies of Member States A and B respectively. Further suppose (a) that X has a debt claim against Y or (b) that X grants Y the use of a patent. In such situations, the directive ***would exempt Y*** from liability to any taxes which might be levied ***in Member State B*** on the interest (variant (a)) or royalties (variant (b)) payed by Y to X.

4. Some observations concerning the relations of the proposal to the OECD model tax convention([1])

The proposal uses definitions similar but not always identical to those of the OECD Model Tax Convention. Some of these divergences are justified, others might lead to confusion.

(a) In substance, the proposal would apply to "***companies of a Member State***".([2]) The Convention applies to persons who are "***residents***" of one or both of the Contracting States.([3]) The notion of residence is further explained as liability to tax by reason of domicile, residence, place of management or any other criterion of similar nature.([4]) Where a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its *place of effective management* is situated.([5])

It might be suggested that there is no necessity for the use of new criteria as national tax authorities are already familiar with the application of the Convention criteria. New criteria should only be used when there is a clearly demonstrated need for them.

(b) Art. 3 (1) (d) of the proposal gives a new definition of what is to be understood by "***permanent establishment***". A much more comprehensive definition of the same term is given in Art. 5 of the Model Tax Convention. It could have been useful to refer to it.

(c) The definition of the notion "***associated company***" given in Art. 3 (1) (b) of the proposal is tailored to the specific needs of the directive. The definition in Art. 9 of the Convention is therefore not appropriate in this case.

(d) The term "***interest***" as laid down in Art. 2 (1) (a) of the proposal is, except for the non-mention of government securities as an example, identical with the term used in Art 11 (3) of the Convention. The enumeration is not comprehensive (arg. "income from debt claims of any kind"; arg. "and in particular".

(e) The term "***royalties***" as defined in Art. 2(1)(b), first phrase, of the proposal is wider and more precise than the term used in Art. 12(2) of the Convention. Art. 2(1)(b) appears to be more comprehensive than Art. 12(2) of the Convention (arg. "payments of any kind received as a consideration for X, Y, Z"). Art. 2(1)(b), second phrase, poses a clear restriction. It would be

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([1]) See footnote 1.
([2]) Art. 1(1) read in combination with Art. 3(1)(a).
([3]) Art. 1.
([4]) Art. 4(1).
([5]) Art. 4(3).

interesting to learn more about the possible economic impact of restrictions or enlargements of the scope of the definition.

(f) The substantial difference between proposal and Convention in the ***treatment of interest*** can be revealed by quoting Article 11 of the Convention:

"1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

"2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the recipient is the beneficial owner of the interest the tax so charged shall not exceed 10 per cent of the gross amount of the interest. [...]"

Paragraph 4 contains an exception for situations where permanent establishments are involved.

(g) The ***treatment of royalties*** is laid down in Art 12 (1) of the convention:

"1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if such resident is the beneficial owner of the royalties."

Paragraph 3 provides an exception to that rule where permanent establishments are involved.

5. Discussion of selected problems

(a) The ***scope of application:*** The directive would *not* apply to just *any* kind of interest or royalty payment. It would only apply to interests or royalties payed between certain associated companies. Therefore, the question of the equality of treatment([1]) arises.

The general exclusion of German or Austrian "Personengesellschaften"([2]) appears to be particularly discriminating.

(b) Between associated companies, the issue of (a) *abnormally high* or (b) *abnormally low* royalty or interest ***payments*** can arise.

([1]) As defined by the European Court of Justice; see e.g. Judgments in cases C-177/90 (Kuhn), C-98/91 (Herbrink), 201/85 (Klensch), C-267/88 (Wuidart) and C-280/93 (Germany vs Council).

([2]) Offene Handelsgesellschaft, Kommanditgesellschaft, Eingetragene Erwerbsgesellschaft, Gesellschaft bürgerlichen Rechts; for Austria cf. Doralt/Ruppe, Grundriß des österreichischen Steuerrechts, Vol. I, 5th ed., Vienna 1994, pp. 162 et s., esp. pp. 167/168.

On the other hand there might be cases of (c) *abnormally generous* or (d) *abnormally restrictive* ***granting of*** advantages which entail interest or royalty payments. In cases (c) and (d) interest or royalty payments can be (i) either abnormally high, (ii) abnormally low or (iii) just appropriate.

The first half of the single phrase of Art. 5 constitutes the solution in case (a).

The second half of Art. 5 contains partial solutions for cases (c)/(i), (c)/(ii) and (c)/(iii).

The proposal, if considered on its own, does not contain solutions for cases (b) and (d). However, these problems can be resolved by the application of certain rules of ***existing national tax law***.

Even in variants (a) and (c) national tax law would complement the directive.

(c) It is by no means easy to establish the ***relationship between Art. 4 and Art. 5.*** However, the distinction is necessary because the legal consequences differ:

Art. 4 applies to "payments purporting to be interest"; in such case the application of the directive ***as a whole*** may be excluded.

Where, under the scope of Art. 5, interests (Art. 5/1 and 5/2) or royalties (Art. 5/1) are involved, the directive shall be applicable only ***to a part*** of the amount.

Any attempt at distinction would raise the following problems:

Firstly, Art. 4 would necessitate the proof of individual intentions ("purporting to be interest"; "income which is treated as"). In practice, it can be nearly impossible to adduce evidence corroborating or even proving such intentions. Secondly, a distinction between the type situations set out in letters a) to d) from a mere 'amount of income or of payments which exceeds the amount which would have been agreed between parties without special relationships' is quite difficult to draw. Both articles thus cover substantially similar, if not identical situations: Situations in which there is a discrepancy between an amount payed and the countervalue obtained. Thirdly, the list given in Art. 4 is not conclusive ("*such as* any of the following").

It seems that practical cases could regularly be subsumed under both articles. The necessity for Art. 4 seems doubtful.

Deleting Art. 4 or introducing an unequivocal distinction between the scope and legal effect of Art. 4 and 5 should seriously be considered.

(d) Art. 6 (1) allows Member States to take measures to combat ***fraud or abuse.*** The intention is helpful, however one might express doubts about its effects on harmonisation.

(e) Art 6 (2) permits the withdrawal of the benefit of this directive "in the case of any transaction which has as its principal objective or as one of its principal objectives ***tax evasion or tax avoidance.***"

Again, proof of *subjective intentions* would be quite difficult if not impossible.

Unfortunately, the notion 'tax avoidance' is so unclear that concerns about its conformity with fundamental rights and the Community legal system have to be expressed.

(f) Surprisingly, the much clearer rule of Art. 7 has only a role ***subsidiary to Art. 6*** ("In addition to the situations covered by Article 1 ..." (Art. 7 (1)). In addition, Art. 7 seems to be aimed at countering the detrimental effects of ***tax competition between Member States***, i.e. situations which perhaps sometimes but not always coincide with tax evasion or tax avoidance. Article 7 applies much clearer criteria and much clearer legal consequences than Article 6.

Consequently, it would appear to be more appropriate to delete Art. 6 (2) and to free Art. 7 from its yoke of subsidiarity *vis-a-vis* Article 6.

Conclusions

In the light of the foregoing the draftsperson would suggest that the Committee on Legal Affairs and Citizens´ Rights call upon the Committee on Economic and Monetary Affairs and Industrial Policy to take into consideration the following conclusions:

1. It should be re-examined to what extent new definitions which differ from the definitions in the OECD Model Tax Convention on Income and on Capital correspond to a real need as the continued use of well-established terms would have several practical advantages.

2. The relationship between Articles 4 and 5 of the proposal should be clarified. This objective might be attained by deleting Article 4.

3. The notion of tax evasion and in particular the notion of tax avoidance are not sufficiently clear. The word 'may' should therefore be replaced with the word 'must' and both concepts should be more clearly defined in the explanatory memorandum.