



**EUROPEAN COMMISSION**  
DIRECTORATE-GENERAL  
TAXATION AND CUSTOMS UNION  
Direct taxation, Tax Coordination, Economic Analysis and Evaluation  
**Direct tax policy and cooperation**

28 January 2011

## **PUBLIC CONSULTATION PAPER**

### **Taxation problems that arise when dividends are distributed across borders to portfolio and individual investors and possible solutions**

**Note:**

**This document is being circulated for consultation.**

**The European Commission has launched this public consultation in order to collect information on any tax problems that arise when dividends are paid across borders to all individual investors and companies with portfolio shareholdings and to obtain suggestions from the public on solutions to any such problems.**

**This document does not necessarily reflect the views of the European Commission and should not be interpreted as a commitment by the Commission to any official initiative in this area.**

The parties concerned are invited to submit their comments no later than

**30 April 2011**

Comments may be sent by letter, fax or electronic mail to the following address:

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## 1. WHAT IS THE AIM OF THIS PUBLIC CONSULTATION?

The levying and crediting of withholding taxes on dividend payments to non-resident portfolio<sup>1</sup> and individual investors in the EU can sometimes be carried out in a discriminatory way. Withholding taxes can, in addition, lead to unrelieved double taxation, distorting the effective functioning of the Internal Market.

In its Dividend Taxation Communication<sup>2</sup> of 2003, the Commission pointed out that Member States could not discriminate in their tax treatment of cross-border dividend income received by individuals. The Court of Justice of the European Union had dealt in several judgments with withholding taxes on dividend payments to non-residents. Drawing from this case-law of the Court of Justice, the Commission concluded that Member States cannot levy higher taxes on inbound dividends than on domestic dividends. Similarly, they cannot levy higher taxes on outbound dividends than on domestic dividends.

In its Communication "Co-ordinating Member States' direct tax systems in the Internal Market"<sup>3</sup> the Commission expressed the view that international double taxation, which arises because of a taxpayer being subject to tax in more than one tax jurisdiction, is a major obstacle to cross-border activity and investment within the EU. In this context, the Commission stated that it was keen to explore with Member States, market operators and other interested parties whether there was a need for an EU-wide coordinated approach to withholding taxes, among other subjects.

More recently, the Court of Justice has delivered judgments in several more cases involving withholding taxes on dividends.

The Commission for this reason believes it is necessary to investigate in more detail the cross-border withholding tax problems faced by portfolio and individual investors in the EU and to investigate any possible solutions.

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<sup>1</sup> Portfolio investors are usually small investors who hold a percentage in the capital of the company paying the dividends which is below 10% (i.e. the threshold above which the Parent-Subsidiary Directive would apply so as to relieve double taxation). They can be companies or individuals. Portfolio investors typically purchase shares in a company, often through a collective investment vehicle, without the intention of influencing management decisions. As investors lack control over companies' decisions, as a result of cross-border reorganisations of the companies in which they invest, it may happen that their domestic shares, have become shares in non-resident companies with all the adverse withholding tax implications this may entail. For the purposes of this paper, under portfolio investors should not be understood those investors who diversify their investments by investing in different investment products (e.g. debt and equity) in order to reduce risk.

<sup>2</sup> Communication from the Commission to the Council, European Parliament and the European Economic and Social Committee "Dividend taxation of individuals in the Internal Market", COM(2003) 810 final of 19.12.2003

<sup>3</sup> COM (2006)823 of 19 December 2006

## 2. WHO IS CONSULTED?

All stakeholders – individual citizens, businesses, Member States, tax administrations, intergovernmental, non-governmental and business organisations, tax practitioners and academia - are invited to provide their views on this matter.

## 3. BACKGROUND

There is an inherent risk of double or multiple taxation of dividends in the hands of receiving shareholders. When dividends are paid cross-border there are generally three layers of taxation:

- corporate income tax on the profits of the dividends distributing company in its Member State of residence
- withholding tax on the dividend payment to the non-resident investor in the source Member State and
- income tax in the investor's Member State of residence.

Dividend payments between Member States' associated companies are in principle exempt from withholding tax under the Parent-Subsidiary Directive<sup>4</sup> provided that certain shareholding and other requirements are met. However, as these requirements are not met in the case of individual shareholders or of companies with a mere portfolio shareholding, dividend payments to such recipients are not covered by the Directive.

Withholding taxes play an important role in dividing taxing rights between a source state of income and the state of residence of an investor. They also help to enforce taxation, thereby preventing tax avoidance and evasion by taxpayers. Nevertheless, the fact that cross-border dividend payments are subject to taxes in two Member States can lead to economic and legal problems within the EU. Withholding taxes may give rise to juridical<sup>5</sup> and economic<sup>6</sup> double taxation problems, discrimination of non-resident investors and distortions of investment decisions (e.g. with regard to the type or location of the investment, etc) in the Internal Market.

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<sup>4</sup> Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation application in the case of parent companies and subsidiaries of different Member States, amended by Council Directive 2003/123/EC of 22 December 2003

<sup>5</sup> "Juridical double taxation" occurs when the same income, such as a dividend, is taxed twice in the hands of the same person: first in the source Member State, when the dividend is distributed (normally by means of withholding tax), and then in the residence Member State, when it is taxed as a part of the same shareholder's taxable income. Juridical double taxation normally occurs in cross-border situations.

<sup>6</sup> "Economic double taxation" occurs when the same profits are taxed in the hands of two different persons, such as dividends taxed first at the level of the company paying the dividends and then in the hands of the shareholders. Such taxation can take place both at a domestic level and at an international level.

Double Tax Conventions (DTCs) based on the OECD Model reduce juridical double taxation on dividends typically by limiting source State taxation on the dividends and by requiring a State of residence of an investor to grant relief for source State taxation through a credit or exemption mechanism. However, source State withholding taxes, even when reduced under DTCs, may not be completely creditable in the State of residence.

The Court of Justice of the European Union (CJEU) has stated<sup>7</sup> that in principle, juridical double taxation is not in itself unlawful, as there is no obligation for Member States to adapt their own tax systems to the different systems of tax of other Member States in order to eliminate the double taxation arising from the exercise in parallel of their fiscal sovereignty. Nevertheless, juridical double taxation represents an obstacle to cross-border activity and investment within the EU, thus distorting the effective functioning of the Internal Market.

Relief from economic double taxation (i.e. for underlying corporate taxes paid by the distributing company in States of source) is often available in purely domestic situations, but not internationally. Thus, such relief is generally not addressed in Double Tax Conventions. Member States are not *per se* required to relieve economic double taxation (except in the cases covered by the Parent Subsidiary Directive). Nevertheless, the CJEU has found that economic double taxation might be contrary to EU law if it reflects a difference in treatment between domestic and cross-border situations, leading to discrimination. Removing discrimination in the tax treatment of dividends paid to portfolio and individual investors is a basic requirement of EU law and a Member State may treat cross-border situations differently from domestic situations only if this is justified by a difference in the taxpayer's circumstances. This may reduce the scope for economic double taxation of dividends, at the level of the source state, in cross border situations.

Even when source State withholding taxes are reduced under Double Tax Conventions, non-resident portfolio and individual investors may suffer interest costs and cash flow disadvantages if relief at the reduced DTC rate is not provided at source. Investors may even forgo the tax relief to which they are entitled under Double Tax Conventions if source States' claim procedures are complicated, costly or time-consuming.

This suggests that the procedures for claiming any tax reductions or exemptions in source countries should be examined. This could include seeing how to streamline the certificates from tax authorities that investors must lodge in order to claim such relief, in conjunction with mechanisms to improve information exchange between tax authorities. In this respect the Commission's Recommendation<sup>8</sup> on withholding tax relief procedures of 19 October 2009 suggests solutions aimed at improving the existing procedures for the reduction of the withholding taxes levied by the source Member States to the lower Double Tax Convention rates. It would, if applied by Member States, only ensure the

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<sup>7</sup> See cases C-513/04, *Kerckhaert and Morres*, of 14 November 2006, C-67/08, *Block*, of 12 February 2009 and C- 128/08, *Damseaux*, of 16 July 2009.

<sup>8</sup> C(2009)7924

proper implementation of solutions to the problem of juridical double taxation to the extent that those solutions are provided for by Double Tax Conventions. It would not resolve problems of juridical double taxation not addressed in Double Tax Conventions, nor would it resolve the problem of economic double taxation.

Furthermore, the reality that the majority of portfolio and individual investors hold their investments indirectly via collective investment vehicles (CIVs) rather than directly in companies, must also be borne in mind. Any solutions to be adopted must take account of the involvement of CIVs either in making claims for tax relief on behalf of their investors or, if resident for tax purposes of the Member States where they are located, on their own behalf.

#### **4. POSSIBLE SOLUTIONS TO THE PROBLEMS FACED BY PORTFOLIO AND INDIVIDUAL INVESTORS**

As it is undesirable in the EU Internal Market that a taxpayer is disadvantaged solely by reason of cross-border investment activity, the Commission is seeking stakeholders' views on possible ways of improving the current situation. The aim should be to ensure that cross-border payments of dividends to portfolio and individual investors will not be taxed less favourably than domestic payments and that any double taxation which may result from the imposition of such withholding taxes is fully eliminated.

The possible solutions presented below have been advocated by various stakeholders in a wide range of tax fora. The Commission services have made a preliminary analysis of their advantages and disadvantages and are now seeking views on the possible solutions outlined below. Stakeholders are also invited to provide any additional suggestions for ways in which double taxation and discrimination of portfolio and individual investors in the EU can be prevented.

##### **4.1. Option 1: Abolition of withholding taxes on cross-border dividend payments to portfolio/ individual investors**

Abolishing withholding taxes on cross-border dividend payments to portfolio/ individual investors is seen as the ideal solution by some commentators. However, like all of the options presented in this paper, this option has both advantages and disadvantages.

###### **4.1.1. Advantages:**

- elimination of juridical double taxation
- elimination of discrimination for outbound dividends
- tax neutrality regarding the place of residence of the dividend distributing company
- simplification of Member States' tax systems
- elimination of cash-flow disadvantages for investors caused by a delay in reimbursement of withholding taxes

- reduction of compliance costs and administrative work for tax authorities, the clearing and settlement industry, and investors
- no conflict with the principle of source-state entitlement to tax; the source state, in its capacity as the residence state of the paying company, already taxes the profits of the company out of which the dividend distributions are made
- more effective supply of equity capital for the source state
- increase in tax revenue of residence Member States which would not have to provide credits for the WHT levied by the source Member State.

#### **4.1.2. Disadvantages:**

- loss of tax revenues for source Member States
- shifting of tax base
- risk of tax evasion by non-resident investors who do not report their income in the residence state, triggering the need to introduce exchange of information between Member States
- costs related to the introduction of automatic exchange of information, i.e. standardised forms, formats and channels of communication, etc.
- any increased opportunity for tax evasion would adversely affect the neutrality of investments made through domestic funds or directly by investors compared with cross-border investments made through foreign collective investment vehicles
- This solution would not address the problem of economic double taxation. It is true that, if the source Member State did not apply any withholding taxes, it would, in effect, be relieving economic double taxation as between the paying company and the investor. Nevertheless, full taxation in the country of residence without credit for the underlying company taxation in the country of source would mean that the investor would, once again, suffer economic double taxation.

#### **4.2. Option 2: The residence State grants full credit for the withholding taxes levied in the source State**

At present there is the possibility that there might not be sufficient income in the Member State of residence against which to offset the withholding tax levied in the country of source. To address this, the Member State of residence of the investor could provide for a full, rather than an ordinary<sup>9</sup>, credit for the withholding taxes levied in the source State. A full credit would imply that where the withholding tax levied in the source State exceeds the actual charge related to such dividend income in the residence State, the tax authorities in the residence State would have to credit the foreign withholding tax in full,

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<sup>9</sup> The ordinary credit is usually limited to the tax rate of the State of residence.

thereby reducing the investor's tax charge on other domestic income or even refunding the surplus tax. Currently as a rule, there are no provisions for full credits included in Double Tax Conventions.

#### **4.2.1. Advantages:**

- reduction or elimination of juridical double taxation, caused by the amount of withholding taxes levied by the source State being higher than the tax levied on the same dividend in the investor's State of residence
- no need to amend existing Double Tax Conventions (tax relief could be provided by the State of residence of the investor on a unilateral basis)

#### **4.2.2. Disadvantages:**

- lower tax revenues in the Member State of residence of the investor
- Member States would have an incentive to attract and lock-in companies which generate tax revenues from dividend payments and this would hinder cross-border business restructuring
- cash-flow disadvantages for investors would not be completely overcome
- economic double taxation would not be remedied.

### **4.3. Option 3: Net rather than gross taxation in the source Member State**

Another solution to the problem that there might not be sufficient income in the Member State of residence against which to offset a withholding tax levied in the country of source would be for the source Member State to limit its taxation in such "over-taxation" cases. Under this solution, the source State would be required to tax a net rather than gross amount of dividend by setting the same proportion of tax free allowances or tax deductions against the dividend as would be set off if the investor was resident in the source State and subject to full taxation in that State.

#### **4.3.1. Advantages:**

- would eliminate the problem of discrimination from the perspective of the source State
- reduction or elimination of juridical double taxation, caused by the amount of withholding taxes levied by the source State being higher than the tax levied on the same dividend in the investor's State of residence
- no need to amend existing Double Taxation Conventions (tax relief could be provided by the source or residence State on a unilateral basis)
- increase in tax revenue for the residence Member States which would have to provide lower credits for the reduced withholding tax levied by the source Member State

#### **4.3.2. Disadvantages:**

- cash-flow disadvantages for investors would not be completely overcome (i.e. they would still have to claim double tax relief to eliminate juridical double taxation)
- lower tax revenues in the Member State of source
- practical difficulties particularly if the costs had to be calculated on an individual basis, but perhaps there would be scope for a 'pro rata' calculation (as would be the case in the state of residence when calculating the tax credit in respect of foreign source dividends).
- no elimination of cross-border economic double taxation.

#### **4.4. Option 4: Application of a general EU-wide reduced rate of withholding tax with information exchange (Neumark solution)**

Another solution favoured by the Neumark report<sup>10</sup> would be to offer taxpayers a choice of either a reduced rate of withholding tax combined with information exchange or higher tax rate if the taxpayer does not opt for information exchange.

##### **4.4.1. Advantages:**

- neither harmonisation, nor abolition of WHT required as effects would be limited to those investors who opt for information exchange
- risk of tax evasion/ avoidance reduced
- a moderate option
- increase in tax revenue for the residence Member States which would have to provide lower credits for the reduced WHT levied by the source Member State

##### **4.4.2. Disadvantages:**

- costs related to the introduction of automatic exchange of information, i.e. standardised forms, formats and channels of communication, etc.
- loss of withholding tax revenues for source Member States
- compliance and administrative costs linked to making claims for the reduced rate of withholding tax not eliminated
- impact on Double Tax Conventions
- The choice between two co-existing procedures (higher rate if no information exchange and lower if information exchange) might lead to further costs for tax administrations
- The WHT would have to be equal to the lowest WHT rate in Member States or would have to stipulate that a lower WHT rate under domestic law would always prevail

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<sup>10</sup> Neumark Report (1962), Rapport du Comité Fiscal et Financier, Luxembourg, 1962.



- Would, again, only address the problem of juridical double taxation, not economic double taxation.

#### **4.5. Option 5. Limitation of both source and residence taxation of dividend income**

The source state could limit its withholding tax and the residence state could give limited underlying tax credit (limited to a certain percentage), as well as credit for the full amount of withholding tax paid in the source country (or exemption). The limited credit or exemption for underlying tax in the country of residence would, in effect, involve a system similar to that applicable on a more comprehensive basis to direct investors under the Parent-Subsidiary Directive.

##### **4.5.1. Advantages:**

- tax evasion/ avoidance reduced
- tax revenue would be shared between the source and the residence Member States
- economic double taxation as well as juridical double taxation would be reduced or eliminated.

##### **4.5.2. Disadvantages:**

- would require investors to present residence certificates
- loss of tax revenues for both the source and residence Member States
- compliance and administrative costs linked to making claims for the reduced rate of withholding tax not eliminated
- Double Tax Conventions would have to be amended
- Complex to administer.

#### **4.6. Option 6. No WHT in the State of source and no taxation of foreign source dividends in the State of residence**

This solution would effectively extend the scope of the Parent-Subsidiary Directive to portfolio investors. However, the logic for exempting payments between related companies under the Parent-Subsidiary Directive may not necessarily apply in the case of dividends paid to portfolio investors, particularly in the case of individuals.

##### **4.6.1. Advantages:**

- elimination of both economic and juridical double taxation
- simplification
- possible increased volume of equity investment in the source State leading to better allocation of capital and resources, resulting in higher level of economic growth and at the end higher profits and higher company tax revenue for the source State.

#### 4.6.2. Disadvantages:

- loss of tax revenue for the source State from the non-levying of WHT
- loss of tax revenue for the residence State
- guarantees would be needed that the profits from which the dividends have been distributed have been effectively and sufficiently taxed in the EU [the issue then would be what is "sufficient tax"].
- the ability to pay principle of the investors would not be taken into consideration
- equity problems in the residence State arising from potentially more favourable tax treatment for dividends from the source State as opposed to domestic dividends, particularly in the case of individuals.

**Finally, another option** that has been mentioned from time to time as a solution to the problems that are created by source country withholding taxes is that the Member State of source would levy a final withholding tax on dividend payments to non-resident portfolio investors, at the same rate as that applicable in the Member State of residence. The Member State of source would then pay over to the Member States of residence the tax collected on non-residents, but without reporting the payments. This option could be a realistic solution if it was combined with information exchange to the country of residence. However, it could favour high income earners in that the ability to pay potential of taxpayers would not be taken into account. It could also create problems of discrimination between foreign and domestic investors, if the domestic withholding tax rate is lower. It could also lead to tax planning and tax avoidance where the withholding tax applied in the State of residence is low or even zero and the tax rate on dividends in the country of source is high.

#### 5. QUESTIONS SUBMITTED TO THE STAKEHOLDERS CONCERNED

With regard to withholding taxes on dividend distributions to portfolio and individual investors, the Commission Services would like to receive contributions from the public.

***All the questions below are optional. The contributions to part II and III of the questionnaire will add to the examples of cases of double taxation submitted by stakeholders in reply to the Commission's Public Consultation on Double Tax Conventions and the Internal Market from April 2010<sup>11</sup>. Any factual information you provide will be used by the Commission services as an evidence base in its evaluation of the real size of the problems and of their financial impact.***

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<sup>11</sup> [http://ec.europa.eu/taxation\\_customs/common/consultations/tax/2010\\_04\\_doubletax\\_en.htm](http://ec.europa.eu/taxation_customs/common/consultations/tax/2010_04_doubletax_en.htm)

## I. General identification of the stakeholder<sup>12</sup>

Name:

Surname:

State of residence:

Contact details:

Are you:

- |   |  |
|---|--|
| <input type="checkbox"/> An individual investor                         | <input type="checkbox"/> A portfolio shareholder |
| <input type="checkbox"/> An organisation representing such shareholders | <input type="checkbox"/> An equity fund          |
| <input type="checkbox"/> Tax administration of a Member State           | <input type="checkbox"/> Academic                |
| <input type="checkbox"/> Tax advisor or tax practitioner                | <input type="checkbox"/> Other (please specify)  |

## II. Problems encountered

1) Which problems, if any, have you encountered due to the EU cross-border levying and refunding of withholding taxes on dividends?

- Double taxation
- Discrimination (please provide details):
- Other (please specify)

2) What was the source of the problem?

- Denial of credit for foreign withholding tax
- Higher taxation of foreign dividends than in purely domestic situations
- Difficulties in obtaining a refund of foreign withholding taxes – the procedures were (please specify): too complex, costly, time-consuming
- Other (please specify)

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<sup>12</sup> In line with the specific privacy statement of this open public consultation, respondents should be aware that contributions received will be published on the internet together with the identity of the contributor unless the contributor objects to publication of the personal data on the grounds that such publication would harm his or her legitimate interests. In this case the contribution may be published in anonymous form. Otherwise the contribution will not be published nor will its content be taken into account.

### **III. Additional costs**

1) Have you suffered any additional costs due to the cross-border investment in dividends?

Yes

No

2) What is the amount of these additional costs and what were they due to?

3) Have these additional costs dissuaded you from investing cross-border?

4) Which was the Member State of source of the dividend (please indicate for each separate case in which you have suffered additional costs)

5) Which is/ was your Member State of residence

### **IV. Possible solutions**

1) Which (combination) of the above outlined solutions do you consider most appropriate to tackle any taxation problems that arise when dividends are paid across border to individual investors or to companies that are portfolio investors? Why do you prefer that option?

2) Would you prefer a completely different solution and if so what solution do you suggest?

3) What, if anything, else do you think could be done at EU level to overcome any difficulties that exist in the area of cross-border withholding taxes on dividends paid to individual and portfolio investors?

4) Are you aware of any statistics or legal or economic studies which could further contribute to the analysis of the costs and benefits of implementing any of the above solutions?

5) Do you have any other comment or thoughts to share as regards cross-border taxation of dividends paid to portfolio and individual investors?