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A COMMON WITHHOLDING TAX ON DIVIDEND, INTEREST AND ROYALTIES IN THE EUROPEAN UNION

Summary

Corporate tax avoidance is high on the policy agenda. Government tax revenues are reduced by a few hundred billion euro according to various estimates due to the avoidance strategies of multinational companies. Both the multinationals firms and the countries facilitating these tax planning strategies have been brought into the spotlight. Also, various EU Member States have been labelled as tax havens.

The multinational firms make use of differences in national tax systems, including differences in withholding taxes on dividend, interest and royalties on outgoing intra-firm income flows. This is called treaty shopping. The Parent-Subsidiary Directive (PSD) and the Interest and Royalty Directive (IRD) are used by multinationals firms to steer their income flows to the Member States with the lowest or zero withholding taxes.

Both directives have been successfully implemented to facilitate cross border income flows within the internal market. However, the conditions of these directives are also used to reduce withholding tax payments on outgoing income flows from the EU.

The authors argue that these directives can be effective tools against corporate tax avoidance with common withholding taxes at the external borders of the EU. The analogy with the external borders and common import tariffs of the internal market seems clear. An internal market without import and export tariffs on cross border goods and services flows would not function properly if every Member State would levy its own tariffs at the external borders. Therefore, the Member States agreed upon common external tariffs. However, this was neglected with the PSD and IRD. This can be corrected with common withholding taxes. Moreover, this proposal is strongly related to recent discussions on minimum taxation of corporate profits to curb tax avoidance and tax competition in the BEPS framework.

The revenues of common withholding taxes could be used by the European Union, as is also the case for the tax receipts on import tariffs. Recently, there has been an intense discussion on the financing of the new EU budget between 2021 to 2027 and the emergency fund to deal with the impact of the COVID-19 crisis. Own taxes by the European Union have also very recently been proposed in this context. Common withholding taxes on outgoing income flows could be a good candidate from this perspective.

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A Common Withholding Tax on Dividend, Interest and Royalties in the European Union

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1. INTRODUCTION

Corporate tax avoidance is high on the policy agenda. According to various articles, the avoidance strategies of multinational companies could reduce government revenues by a few hundred billion euro. Although these strategies are legal, many multinationals are accused of acting unethical. These firms exploit the differences in national tax systems to reduce or even to avoid tax payments.

Countries facilitating these tax planning strategies have also been brought into the spotlight. Last year the European Parliament (EP) labelled countries such as Cyprus, Hungary, Ireland, Luxembourg, Malta and the Netherlands as tax havens.[1] Furthermore, the European Commission (EC) accused these countries of having aggressive tax policies.[2] Based on Torslov et al. (2018), the EC and EP state that about 50 to 70 billion euro is lost each year due to corporate tax avoidance and these numbers are considered to be conservative estimates.[3] The Member States labelled as tax havens are accused of being responsible for these government revenue losses.

The EC took various initiatives to curb tax avoidance. One was the revival of the common consolidated corporate tax base for multinational firms, originally proposed in 2011. With a consolidated tax base in the EU, tax avoidance strategies within the EU would have no impact on the tax base. The EU was also active in the BEPS discussions within the OECD and actively implemented various BEPS action points formulated in 2015, such as the Anti-Tax Avoidance directives (1 and 2).[4] The EC also proposed a common tax on the sales of digital services of multinationals not physically present in the Member States in response to the initiatives of individual Member States.

We discuss to levy a common withholding tax on outgoing dividend, interest and royalty flows at the common border of the EU. In this policy brief, we will argue that the Parent-Subsidiary Directive (PSD) and the Interest and Royalty Directive (IRD) can only be effective against tax avoidance with common withholding taxes at the external borders of the EU. Both directives have been successfully implemented to facilitate cross border income flows within the internal market. However, the conditions of these directives are also used to reduce the tax burden of withholding taxes on incomes flowing out of the EU. The directives made it possible that multinationals searched for Member States with the lowest or even zero tax rates on outgoing dividends, interest and royalties. Common withholding taxes could prevent this. This could reduce the amount of corporate tax avoidance within the EU enormously as we will show later.

The discussed tax is a minimum tax at the common border, allowing Member States to apply higher rates. Such a tax is very much in line with the OECD/G20 discussions on minimum taxation to put a common floor in the taxation of passive income. These initiatives aim to curb tax avoidance as well as tax competition.

[1] European Parliament, 2019, European Parliament resolution of 26 March 2019 on financial crimes, tax evasion and tax avoidance (2018/2121(INI)).
[2] European Commission, 2018, European Semester: country reports.
[3] European Parliament, 2015, Bringing transparency, coordination and convergence to corporate tax policies in the European Union, study of the European Parliamentary Research Service European, Added Value Unit
PE 558.776 - October 2015
[4] OECD, 2015, Base Erosion and Profit Shifting, Paris.

Additionally, the revenues of common withholding taxes could be used by the European Union as is also the case for the tax receipts on import tariffs at the customs. Currently, there is an intense discussion on the size and financing of the new EU budget between 2021 to 2027 and on financing the emergency funds to deal with the impact of the COVID-19 crisis. The question is to what extent the Member States have to contribute to these budgets. A new EU tax could be a solution for members who do not want to contribute too much and could create more flexibility in the EU budget. Own taxes by the European Union are also very recently proposed to finance to some extent the emergency funds. A common withholding tax on outgoing income flows could be a good candidate from this perspective.

2. OWN RESOURCES FOR THE EUROPEAN UNION

The budget of the European Union is mainly financed by contributions of the Member States. Already for decades, there are discussions on extending the own financial means of the EU, in particular by levying own taxes. Then the EU would be financially less dependent on the contributions the Member States and could have a more flexible budget policy which would allow the EU to adapt to changing economic and social circumstances, instead to be subjected to the seven-year periods of detailed budget planning. Many proposals for own taxes have been formulated in the past such as import levies, taxing multinationals, $C0_2$ taxes and a digital services tax (DST).

Very recently the European Commission suggested a new tax on multinationals active on the single market to finance the recovery fund. That fund involves an enormous economic stimulus of €750 billion to overcome the COVID-19 crisis in Europe. In order to finance this, the EC wants to borrow the resources from the financial markets, but also wants to raise around €50 billion annually with the revenues of new EU taxes. These include a carbon tax, a levy on single-use plastics, the extension of the Emission Trading System, and the European digital services tax. The fifth one is a new tax on multinationals with global revenues of €750 million or more and active on the single market.

The details of this new tax are not clear, it is even not decided whether this is a direct tax on profit income or an indirect tax. A possible interpretation of a new tax on multinationals could be an EU-wide withholding tax on interest and royalties and dividends at the external borders for intra-firm payments. This would be a direct tax on profit income transferred outside the EU. It would not apply on transactions between Member States. We will motivate the benefits of common withholding taxes below.

3. TREATY SHOPPING IN THE EU

The common withholding tax is a solution for the practice called treaty shopping. This is a tax avoidance strategy of multinational firms. The term "treaty shopping" is used in the neutral sense of indirect routing. "Treaty shopping" thus is not to be understood as "treaty abuse" as it is defined between two jurisdictions without being a resident of one of those jurisdictions".[5] If the said person or legal entity had been a resident of one of the treaty jurisdictions, the treaty benefits would automatically apply.

Double tax treaties aim to avoid or at least reduce double taxation. Tax treaty shopping is a method of paying fewer withholding taxes, making use of the lower agreed rates in the treaty instead of the higher standard rates. This may be financially and economically advantageous, not only for the individual or firm but also for a jurisdiction. Withholding taxes on dividends determine, together with the corporate tax, the tax burden on the capital income of shareholders. Treaty shopping could be a strategy to lower the tax burden.

Van 't Riet and Lejour (2018)[6] formalise the notion of realising the full potential gain of treaty shopping over a large set of jurisdictions. They consider the international corporate tax system as a transportation network. In the network analysis, 'shortest' paths are computed which minimise the tax payments of MNEs when they repatriate profits. The tax 'distances' between countries are constructed from corporate tax rates, withholding taxes on dividends and double taxation relief methods. Also, the reciprocally reduced withholding tax rates in bilateral tax treaties are included. MNEs can reduce the tax burden on repatriated dividends by choosing the 'cheapest' tax route in the network. This may be an indirect route involving a conduit country and treaty shopping. MNEs may take advantage of treaty provisions not found between the ultimate host and home country of their investment.

In a network of 108 countries, and with data from the year 2013, van 't Riet and Lejour (2018)[7] conclude that treaty shopping leads to an average potential reduction of the tax burden on repatriated dividends of 6 percentage points. For two-thirds of all country pairs in the network, an indirect tax route is cheaper than the direct route.

Using a centrality indicator from the network analysis, the most important conduit countries are identified; the United Kingdom, Luxemburg and the Netherlands. The top 10 of conduit countries comprises of nine European countries (see Table 3).

[5] For a thorough discussion of treaty shopping, see S. van Weeghel: *The Improper Use of Tax Treaties*, Kluwer, 1998.

[6] Van 't Riet M. and A. Lejour, 2018, Optimal Tax Routes: a network analysis of FDI diversion, *International Tax and Public Finance 25(5)*, 321-1371.

[7] We ignore the Brexit: the United Kingdom was a member of the EU in 2018, and so it is in the baseline.

4. THE ROLE OF THE PARENT SUBSIDIARY AND INTEREST AND ROYALTY DIRECTIVES

Why are so many Member States identified as conduit countries? The main reasons are, first, that the countries apply full double taxation relief on incoming dividends if the residential holding has a substantial share in the foreign holding. This implies that no corporate tax is levied on incoming dividends. Second, the Member States are not allowed to levy a withholding tax on outgoing dividends to other Member States if it is an intrafirm income flow.

These two conditions are agreed upon by the Member States in the EU Parent-subsidiary directive (PSD) from 1991.[8] This directive was implemented to stimulate the internal market in Europe and created conditions on the distribution of intra-firm profits comparable to those within Member States. From 2004 onwards these two conditions were also applied on interest and royalty flows between EU Member States (IRD).[9] Due to both directives, cross border transactions concerning dividends, interest and royalties, were no longer subject to taxation, if these flows are intrafirm flows.

This created interesting tax planning constructions. Take the example of royalties earned by the world-famous pop band U2. They were residing in Ireland, but Ireland introduced a withholding tax of 20% on outgoing royalties in 2006. It became much more expensive to distribute royalties to other countries. The management of U2 decided to set up an office in the Netherlands, located at the Herengracht, one of the beautiful canals in Amsterdam. Why? The Netherlands does not levy a withholding tax on interest and royalties (until 2021[10]) and the Irish withholding tax did not apply to intra-EU royalty flows. The Rolling Stones have an office at the same address. From the Netherlands, royalties could flow tax-free to tax havens in the Caribbean, where Mick Jagger has a residence.

Big American MNEs with holdings in Ireland, such a Google, acted similarly. International royalty flows boomed after introducing the IRD. In 2015 Ireland forbade this tax planning construction for new situations but allowed a five-year period for existing cases.

Another example is American MNEs with holdings in South America, e.g. Chili. These countries levy in general high withholding taxes of about 30% on outgoing dividends. However, due to a favourable tax treaty with Spain, the former colonizer, the tax is not applied on flows to Spain. Moreover, the Netherlands is one of the few European countries that does not levy a withholding tax on dividends to the USA in various circumstances, due to the double tax treaty between the USA and the Netherlands. Then it is much cheaper to divert the dividends via Spain and the Netherlands to the headquarter of the MNE in the USA.

[8] Parent-Subsidiary Directive – Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States. Amended by Council Directive 2003/123/EC of 22 December 2003.

[9] Interest and Royalties Directive - Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

[10] From 2021 the Netherlands will levy a withholding tax of 21.7% on interest and royalty flows to a set of low tax jurisdictions. This is referred to as the conditional withholding tax.

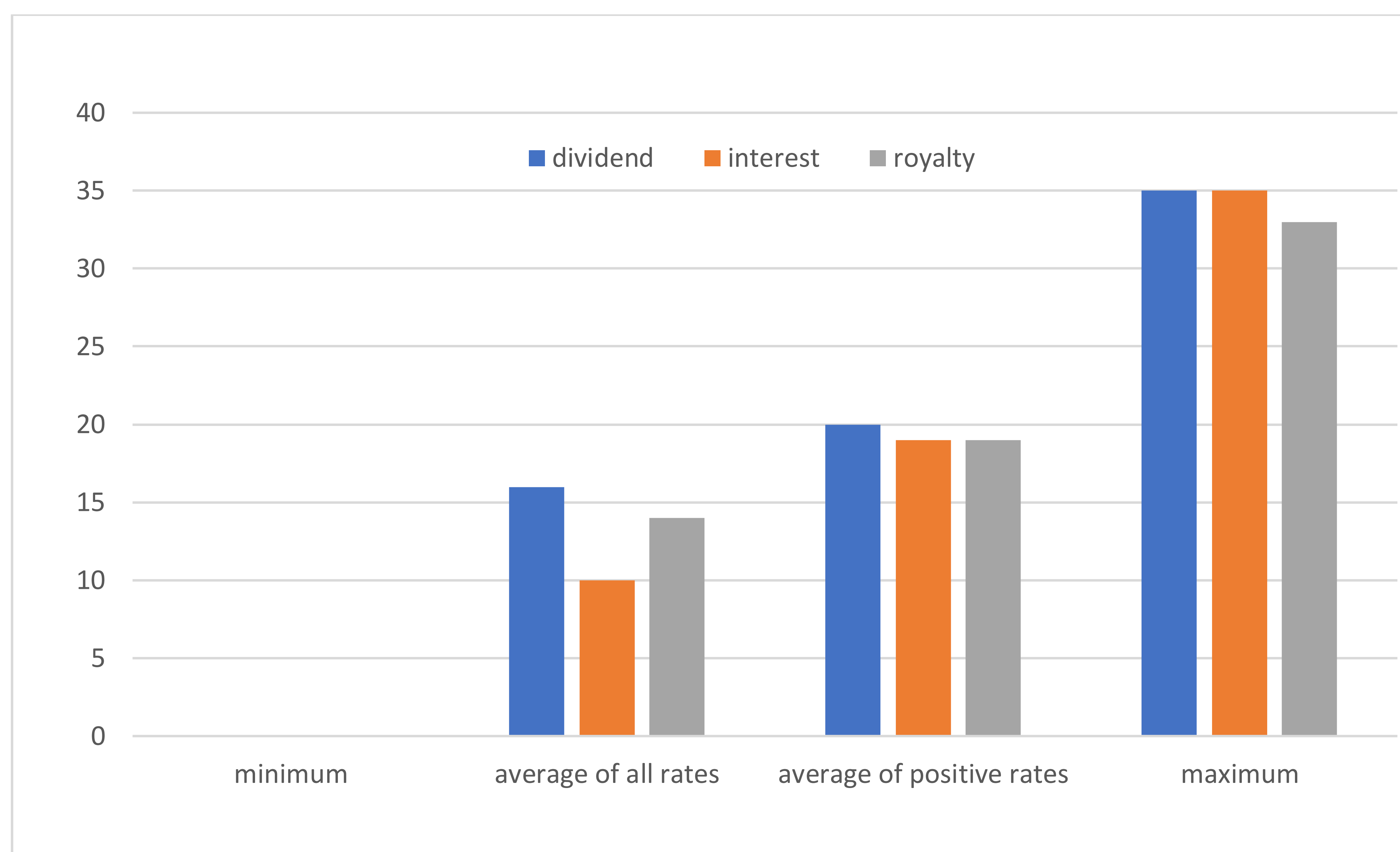
5. COMPARISON WITH THE INTERNAL MARKET

These examples were not the type of firm behaviour which were intended by implementing these directives. However, it is not strange that these tax planning strategies are devised. This could have been foreseen, in particular, if one realizes the analogy with the internal market in the EU.

From trade theory, we know that customs unions and the internal market should have a common border for imported goods and services with common import tariffs. If this is not the case, like in a free trade area, rules have to be designed to avoid the misuse of the agreed elimination of import tariffs at the internal border of the participating countries, the so-called rules of origin. These rules are imposed to guarantee that a substantial part of the product is produced in a member of the free trade area before it crosses the internal border. This prevents the possibility that multinationals outside the free trade area export to member states of the free trade area via countries levying the lowest import tariffs. In the case of common tariffs at the external borders, these rules of origin are not necessary.

However, for cross border dividend, interest and royalty payments, this is completely different as the examples above illustrate. Withholding taxes on these outgoing payments differ substantially within the EU. Below we present the standard withholding taxes in the Member States. The rates in bilateral tax treaties are often lower, but not to tax havens, because most countries do not have treaties with these jurisdictions.

Figure 1: Standard withholding tax rates in the EU on outgoing payments, 2018[11]



[11] These table is based on the withholding taxes in the 27 Member States and Iceland, Norway and Switzerland, because these EFTA countries also subjected themselves to the PSD and IRD. Data source: IBFD.

The rates vary between zero and 35%. On average the tax rate on interest payments is 10% and on dividend and royalty payments it is 6%-points and 4%-points higher. The low average rate on interest is due to the relatively large number of countries without a withholding tax. Correcting for this, the average tax rate is about 20% for countries levying a withholding tax.

Although the withholding tax rates in tax treaties are often 5 to 10% points lower than the standard rates, similar patterns can be found. The countries with hardly any withholding taxes are also prominent conduit countries.

For the PSD and IRD common withholding taxes were not envisaged, and that created tax planning possibilities for MNEs. The analogy with the internal market would ask for common withholding taxes on dividends, interest and royalties.

Table 1: EU Member States without a withholding tax in 2018

Zero tax rates	Member States
Dividend, Interest and Royalties	Cyprus, Hungary, Latvia and Malta
Dividend	Estonia, Slovakia
Interest and Royalties	Luxembourg, Netherlands, Norway, Sweden
Interest	Austria, Denmark, Finland, France, Germany

6. A COMMON WITHHOLDING TAX ON DIVIDEND, INTEREST AND ROYALTIES

A common withholding tax on royalties leaving the EU would have mitigated the incentives of multinationals, and pop bands, like the Rolling Stones and U2, to establish a Dutch holding, because there would be no tax gain in transferring royalties out of the EU. A common withholding tax on dividends would have eliminated the same incentive of other multinationals. Multinationals firms would have no incentive for using Cyprus, Hungary, Latvia or Malta as pass-through countries. This is also the case for Estonia and Slovakia and with respect to dividends and countries like Luxembourg and the Netherlands for interest and royalty payments.

The possible 'tax revenue leakages' were also emphasized in a recent decision of the European Court of Justice on the Danish beneficial ownership cases" (hereafter "the Danish BO cases"), regarding the exemption of withholding taxes based on the PSD and the IRD in abusive situations.[12] The Danish tax authorities argued in the cases that the directives did not apply, and the tax exemption was denied because the relevant payments eventually ended up in third, non-EU countries, rendering the interposed EU holding companies mere conduits. The cases were referred by the Danish national courts to the European Court of Justice with a request for a preliminary ruling to establish the interpretation of the EU law. The Court decided favourably for the Danish tax authorities in 2019.

The idea of common withholding taxes is not completely new. Already in 1997, Huizinga and

[12] Baerentzen, S., A. Lejour and M. van 't Riet, 2020, Limitation of holding structures for intra-EU dividends: A blow to tax avoidance?, *World Tax Journal*, February 2020.

Nielsen[13] analyzed a common withholding tax on interest. That was earlier proposed by the European Commission in 1989.[14]

The EC proposed a tax of 15%, the average tax of the Member States at that time to counter the problems of distortions, tax avoidance and evasion. Huizinga and Nielsen concluded in a theoretical model with two EU countries and a non-EU tax haven that the impact for the low-tax country in the EU could be negative. More recently, Finke et al. (2014)[15] investigate the possibilities for withholding taxes on interest and royalties for limiting corporate tax avoidance in source countries. In their simulations, they propose a 10% tax on outgoing royalties.[16]

The European Parliament proposed a common EU withholding tax in 2016 on outgoing profits.[17] However, these ideas are still not developed into directives. It will be probably hard to achieve consensus by the Member States because these have autonomous decision rights on tax policy and could veto every proposal on taxation policy.

For reducing the differences in tax rates between member states, the level of the rates should probably be at least 10%, and 20% at most. 10% is the average withholding tax rate on interest and 20% is the average of those countries with a tax (see figure 1). If the tax rate is less than 10%, the tax will hardly be effective against corporate tax avoidance. Most countries levy at least withholding taxes at a 15%-rate, a 10%-rate is an exception (if a tax is levied).

7. EXAMPLE: MINIMUM WITHHOLDING TAX ON DIVIDEND

Whether the rate of a common withholding tax is 5, 10 or 15%, it will have a large impact on the conduit role of a number of Member States. A few years ago, we examined the effects of a minimum withholding tax of 5% on dividends, including Norway, Iceland and Switzerland.[18] With a minimum tax, we implied that Member States with lower tax rates increased the rate until 5% and Member States with higher tax rates did not change them.

We compared the gains of tax treaty shopping for MNEs before (initial) and after the introduction of the minimum tax (see Table 2). At a global level, the effects are limited despite the big weight of the EU in the world economy. The gains of treaty shopping are only reduced from 6.0% to 5.4%. For the EU countries, the effects are larger. The gains of treaty shopping are reduced by 1.8%-points from 7.3% to 5.5%. The benefits from treaty shopping using

[13] Huizinga, H. and S.B. Nielsen, 1997, The taxation of Interest in Europe: a minimum withholding tax?, CentER Discussion Paper, 1997-73.
[14] EC, 1989, Proposal for a Council Directive on a Common System of Withholding Tax on Interest Income, COM(89) 60/3/Revision final, Brussels.
[15] Finke, K., C. Fuest, H. Nusser and C. Spengel, 2014, Extending Taxation of Interest and Royalty Income at Source – an Option to Limit Base Erosion and Profit Shifting?, ZEW Discussion Paper No. 14-073.
[16] All those proposals, including ours, violate agreements in existing tax treaties and assume effectively that treaty override is possible. Whether or not this is possible is beyond the scope of this paper, but requires attention.
[17] European Parliament, 2016, MEPs call for tax haven blacklist, patent box rules, CCCTB and more, press release.
[18] A. Lejour and M. van 't Riet, 2017, Effect van een Europese bronbelasting op dividend op belastingontwijking, Economisch Statistische Berichten, year 102, 10 October 2017 (in Dutch).

dividends are reduced by 30% in the EU while the minimum tax rate is only 5%.

There are large differences in the top 10 of conduit countries (see Table 3). From 8 European countries (excluding the UK) only two of them, Luxembourg and the Netherlands are in the top 10 if the common withholding tax with a 5% rate is introduced. Based on these outcomes Cyprus, Hungary and Ireland would not qualify as conduit countries or tax havens any longer. However, investment flows and the returns on investment will be diverted via other conduit countries. So, there are many new conduit countries, like Australia and Malaysia. The shift of the conduit role to other countries explains the modest effects at the global level.

This is only an example of a withholding tax on dividends with a 5% rate which has a large impact on the position of European conduit countries. This effect will be reinforced with higher tax rates and with a common withholding tax for interest and royalties. Then the global effects will probably be more substantial.

Table 2: Average tax burden on dividend routes (combined dividend tax in %)

	Initial situation			**Minimum withholding tax of 5%**		
	Direct	**Optimal**	***Difference***	**Direct**	**Optimal**	***Difference***
Global	11.9	5.9	*6.0*	12.0	6.6	*5.4*
EU (outgoing)	12.8	5.5	*7.3*	13.3	7.8	*5.5*

Table 3: Top 10 conduit countries based on centrality measure[19]

Initial situation			**Minimum withholding tax of 5%**		
1	United Kingdom	13.4	**1**	Australia	9.3
2	Luxembourg	8.4	**2**	Singapore	8.6
3	Netherlands	7.7	**3**	Malaysia	7.7
4	Estonia	6.7	**4**	United Kingdom	5.9
5	Hungary	6.2	**5**	Mauritius	5.8
6	Singapore	6.1	**6**	Hong Kong	5.6
7	Ireland	5.6	**7**	United Arab Emirates	4.8
8	Slovakia	5.3	**8**	Brunei	4.7
9	Finland	4.7	**9**	Luxembourg	4.3
10	Cyprus	4.5	**10**	Netherlands	4.3

[19] The centrality measure counts the number of times a country is on the tax routes as intermediate country (no source or final destination) divided by all optimal tax routes. So, the UK is a conduit country in 13.4% of all optimal tax routes.

8. TAX REVENUES

It is hard to estimate the effect on tax revenues as the network analysis applied above is only based on the differences in tax rates and not on the actual financial flows between countries. At the global level, the size of the cross-border dividends amounts to 1250 billion dollars.[20] Due to phantom or diverted investments, also the returns on investment are diverted and double-counted.[21] May be one third to 50% of the bilateral dividend flows is not double-counted. Assuming that the EU is a quarter of the world economy, the annual revenues of a minimum tax on dividends are 10 to 15 billion euro (if the rate is 10%). In this example, we assumed that the revenues of the higher tariffs on top of the 10% accrue to the Member States.

Dividend flows are larger than interest and royalty flows, but common withholding taxes on these latter two-income flows could also create revenues in the order of 10 billion euro annually. This suggests that common withholding taxes on dividend, interest and royalties could be a major source for own revenues of the European Union.

Of course, most Member States already levy withholding taxes, so a common tax would shift resources from those Member States to the Union. This shift would be mitigated by only granting the tax revenues to the EU in so far these are generated by the common tariff. The revenues of higher national tariffs, on top of the common tariffs, are still for the Member States. Moreover, a transition period could be introduced before the revenues are granted fully to the Union.

[20] Hanappi, T. A. Lejour and M. van 't Riet, 2015, Network analysis of tax treaty shopping using dividend-based weights, CPB Communication, August 28, 2015.

[21] Damgaard, J., T. Elkjaer and N. Johannesen, 2019, The rise of phantom investments, IMF paper, and Van 't Riet and Lejour, 2018, ibid.

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