

## Comment

In response to the public consultation paper issued by the  
European Commission, 28th of January 2011

on

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

by

Prof. Dr. Christoph Spengel, University of Mannheim  
and Centre for European Economic Research, Germany

Lisa Evers, Centre for European Economic Research, Germany

**20<sup>th</sup> of April 2011**

Prof. Dr. Christoph Spengel

Universität Mannheim

Schloss, Ostflügel

68131 Mannheim

Phone: +49 (0) 621 - 181-1705

[spengel@uni-mannheim.de](mailto:spengel@uni-mannheim.de)

<http://spengel.bwl.uni-mannheim.de>

Lisa Evers

ZEW GmbH

L7, 1

68161 Mannheim

Phone: +49 (0) 621 - 1235-168

[evers@zew.de](mailto:evers@zew.de)

[www.zew.de](http://www.zew.de)

## 1. Introduction

The EU Commission identifies two major shortcomings of the cross-border taxation of dividends received by portfolio shareholders in its consultation paper. Firstly, withholding taxes may be levied and credited in a discriminatory manner which may constitute an infringement of the free movement of capital set out in Articles 63 to 66 of the Treaty on the Functioning of the European Union. Secondly, the imposition of withholding taxes may result in double taxation and as a consequence impede investors from investing in foreign corporations. Hence, the benefits of international risk diversification are not fully exploited which may result in welfare losses.<sup>1</sup> The parent-subsidiary-directive<sup>2</sup> addresses this issue by prohibiting the imposition of dividends paid to substantial shareholdings. A comparable relief is, however, not available for portfolio and individual investors. In turn, withholding taxes on interest have been considerably reduced and even abolished by many member states whereas withholding taxes on dividends are still common and significant.<sup>3</sup> This report therefore discusses how the above highlighted issues concerning the cross-border taxation of dividends received by individuals can be resolved. The taxation of portfolio investments by corporations which is also left out of the scope of the parent-subsidiary-directive is not addressed in the following as this issue requires a separate analysis.

The report is organised as follows: At first, the shortcomings of the taxation of cross-border dividends received by individuals under the law in force are pointed out in chapter two. In this respect, the focus is on depicting the causes of double taxation. In addition, broad guidelines for eliminating double taxation are derived. These basically correspond to the reform options presented in the consultation paper. In chapter three, normative criteria for the taxation of cross-border dividends are presented. These are efficiency and neutrality, simplicity and enforceability as well as individual equity and the allocation of taxing rights among the residence and the source country. A solution to the highlighted shortcomings of the cross-border dividend taxation is finally presented in chapter four. In accordance with the criteria of chapter three, the options pointed out in the consultation paper are discussed as well. The final chapter offers a conclusion.

## 2. Shortcomings of the cross-border taxation of dividends received by individuals

The two main shortcomings of the cross-border taxation of dividends received by individuals are firstly economic and juridical double taxation of such dividends and secondly the discriminatory imposition and crediting of withholding taxes by the source country respectively the country of residence. In the following, causes and guidelines for resolving these two main issues are pointed out. These will constitute the starting point for the evaluation of possible reform options carried out in chapter four.

Dividends received by individual investors are often subject to three layers of taxation: corporate income tax and withholding tax in the source country and personal income tax in the country of residence. This may lead to juridical and economic double taxation. **Juridical double taxation** occurs in case a withholding tax is imposed at source in addition to personal income tax levied in the country of residence. In turn, **economic double taxation** arises if distributed profits are taxed on the level of

---

<sup>1</sup> See Fuest & Huber, 2001, p. 518.

<sup>2</sup> Council Directive 2003/123/EC.

<sup>3</sup> See Magliocco & Sanelli, 2009, p. 200.

the company as well as in the hands of the shareholders by way of a withholding tax or personal income tax.

Double taxation of foreign dividend income may deter investors from purchasing foreign shares and therefore constitutes a major obstacle to cross-border investment within the European Union. As **Juridical double taxation** occurs in case both the source and the residence country tax dividend payments it may be prevented by the country of residence by way of granting an unlimited tax credit. Tax credits for foreign withholding taxes are, however, usually limited to the domestic tax payable on the respective kind of income. Hence, even in case a tax credit is granted juridical double taxation may persist in case the withholding tax rate exceeds the domestic tax rate. For this reason, in line with article 10 of the OECD model convention many countries on a bilateral basis restrict the permissible withholding tax rate applied to dividends paid to individuals to 15%. But, for several reasons this tax treaty relief may not be effective. Firstly, withholding taxes are generally levied on gross dividends whereas most member states of the European Union still determine personal income taxes on a net basis taking into account personal allowances and deposit fees or the like.<sup>4</sup> Consequentially, even deciding on low withholding tax rates on a unilateral or bilateral basis may not prevent excess tax credit positions in all cases. Secondly, individual investors may even waive their option to apply the reduced treaty tax rate in case the administrative procedures related to this relief are considered to be too complex and costly.

Finally, even in case part of the withholding tax is eventually refunded because the reduced tax treaty rate applies, the investor still has to burden compliance costs and the time-value of money due to the delayed refund. In addition, the imposition of withholding taxes results in a liquidity disadvantage as withholding taxes are immediately deducted whereas personal income tax may be declared within several months after the end of the tax year. Even in case juridical double taxation is finally prevented, these costs constitute a final burden for the investor and may deter individuals from investing abroad.<sup>5</sup>

Summing up, juridical double taxation may first of all be prevented by abolishing withholding taxes levied at source (1). In case withholding taxes continue to exist on the current level, the issue of juridical double taxation may only be resolved in case the residence country grants an unlimited tax credit (2). An alternative option is to align the determination of the tax base of the withholding tax and the personal income tax by either levying them both on a net (3a) or a gross basis (3b). Finally, the issue of juridical double taxation could also be mitigated - but probably not finally resolved - by further reducing withholding tax rates preferably on a unilateral basis in order prevent excess tax credits (4).

**Economic double taxation** of dividends occurs because dividends are subject to corporate income tax on the level of the company and withholding tax and/ or personal income tax in the hands of the shareholder. The country of residence may eliminate economic double taxation by granting an unlimited indirect tax credit for the underlying profit taxes as well as for the withholding tax levied at source on the dividends. This would imply that the residence country even provides for a refund in case the foreign tax burden exceeds the domestic personal income tax liability. These are, however, only theoretical considerations, as countries in line with Article 23B of the OECD Model Tax Conven-

---

<sup>4</sup> See Vann, 2003, p. 49.

<sup>5</sup> See Magliocco & Sanelli, 2009, p. 203.

tion generally restrict foreign tax credits to the domestic tax liability related to the respective foreign income. Though, economic double taxation may be to some extent mitigated in case the residence country grants a limited indirect tax credit for corporate income tax levied at source (5). Besides this, economic double taxation does not occur in case the source country refrains from imposing a withholding tax and the country of residence additionally exempts the dividends from personal income tax (6). Hence, the issue of economic double taxation cannot be discussed without referring to the domestic tax systems for integrating corporate income tax into personal income taxation. This is in turn also influenced by the level of corporate income tax and the personal tax rate applied to interest. This report is, however, based on the perception that the domestic tax systems of the member states need to be taken for granted for the analysis of the cross-border taxation of dividends received by individuals. We presently consider any proposal that requires as far-reaching changes as a harmonisation of dividend taxation systems to be infeasible.<sup>6</sup> Therefore, this report does not promote any reform options that require a fundamental reform and harmonisation of the domestic dividend taxation systems. Against this background, several of the options presented in the consultation paper are not considered to be suitable.

Summing up, eliminating economic double taxation is not as straight forward as eliminating juridical double taxation. Nevertheless, abolishing withholding taxes may mitigate the issue or even eliminate it in cases in which the residence country exempts dividends from personal taxation.

Finally, the issue of possible **discriminations** of inbound or outbound equity investments has to be addressed. European law first of all requires that cross-border dividends may not be not be taxed less favourably than domestic dividends. Hence, the withholding tax imposed on foreign dividends from inbound investments may not exceed the combined tax burden of domestic dividends taking into account domestic withholding taxes as well as personal income tax.<sup>7</sup> Secondly, outbound investment should not be discriminated against through granting more favourable relief for double taxation to domestic dividends.<sup>8</sup> This inevitably restricts the scope of action of the national legislators to encounter economic double taxation which are usually not willing to provide tax credits for foreign corporate income tax.<sup>9</sup> It does, however, not imply that economic double taxation has to be eliminated altogether on the grounds of European Law. Eliminating juridical and economic double taxation therefore constitutes a stricter requirement than ensuring conformity with European Law.

### **3. Objectives and assessment criteria for reforming the cross-border taxation of dividends received by portfolio investors**

The shortcomings of the cross-border taxation of dividends highlighted in the previous chapter first of all relate to the requirement of ensuring the free movement of capital movement set out in Articles 63 to 66 of the Treaty on the Functioning of the European Union as well as to the criteria of efficiency and neutrality which constitute fundamental principles for tax policy. Further well established

---

<sup>6</sup> See Schön, 2009, 85.

<sup>7</sup> See European Commission, 2003, p. 17; Graetz & Warren, 2007, p. 1618; ECJ, 6 June 2000, C-35/98; ECJ, 22 December 2008, C-48/07, para 47.

<sup>8</sup> See European Commission, 2003, pp. 13 et seq.; Graetz & Warren, 2007, p. 1618; ECJ, 12 December 2006, para. 46, and the case law cited therein.

<sup>9</sup> As a result of the case law of the ECJ on the discriminatory application of imputation systems, several member states have replaced their imputation systems by shareholder relief systems as they are reluctant to grant indirect tax credits for foreign corporate income tax. See Graetz & Warren, 2006, p. 1211; Griffith et al., 2010, 949.

assessment criteria are simplicity and enforceability as well as individual equity and the allocation of taxing rights. These criteria are described in more detail in the following. Reference is being made to the guidelines for addressing the issue of discriminatory taxation of dividends and double taxation highlighted in the previous chapter.

### **3.1. Conformity with European Law**

Violations of European law, namely the free movement of capital according to Articles 63 to 66 of the Treaty on the Functioning of the European Union constitutes one of the two major shortcomings of the cross-border taxation of foreign dividends in the European Union as highlighted above. Consequentially, the source country should not tax dividends paid to foreign investors less favourably than domestic ones.<sup>10</sup> In turn, the country of residence should treat foreign dividends as favourably as domestic dividends.<sup>11</sup> Though, European Law does not offer any guidelines how to prevent economic double taxation whether by way of imputation credits or exemption of dividends. By requiring that a domestic imputation system is extended to foreign dividends granting a credit for foreign corporate income tax is does, however, practically limit the scope of reform options. Moreover, European Law is not opposed to levying withholding taxes, which play a crucial role with respect to double taxation. Finally, high compliance costs may also constitute infringements to the fundamental freedoms.<sup>12</sup> Summing up, European Law constitutes a constraint for reforming dividend taxation but does not serve as the central guideline for eliminating double taxation.

### **3.2. Efficiency and neutrality considerations**

Efficiency constitutes a fundamental principle for tax policy which is also inherent in the Treaty on the Functioning of the European Union (Art. 120). It requires that taxation should not distort the efficient allocation of capital through market mechanisms. This comprises that investment decisions – including the decision whether to invest in the shares of a domestic or a foreign company - are not distorted by taxation.<sup>13</sup> In order to promote the efficient allocation of portfolio investment within the European Union, juridical and economic double taxation need to be eliminated.

Distortions of location decisions are traditionally analysed by way of the concept of capital export neutrality (CEN). From the perspective of the residence country CEN may be achieved by taxing the worldwide income on an accruals basis and granting an unlimited credit for foreign taxes. Hence, the tax burden and consequentially the rate of return are not affected by the location of an investment. That ensures that the allocation of capital is not distorted by taxation.<sup>14</sup> Achieving CEN on the level of the individual investor requires that all levels of corporate income tax paid by the members of a multinational group of companies are fully taken into account. Nowadays, this has to be considered infeasible unless corporate taxation is fully harmonised.<sup>15</sup> Hence, CEN does not constitute a useful guideline for the taxation of portfolio equity investments.<sup>16</sup> Beyond that, when taking into account

---

<sup>10</sup> See footnote 5.

<sup>11</sup> See footnote 6.

<sup>12</sup> See ECJ, 7 September 2006, C-470/04, para. 49. Englisch, 2010, p. 205.

<sup>13</sup> See European Commission, 2001, S. 26.

<sup>14</sup> See Devereux, 2008, p. 701 f.

<sup>15</sup> In case corporate income taxes differ, CEN with respect to portfolio investment requires that the differences in the corporate income tax rates are offset by personal taxes. See Devereux, 2000, S. 122 f.; Owens, 2006, p. 562; European Commission, 2003, p. 19.

<sup>16</sup> See European Commission, 2003, p. 19.

the large importance of portfolio investment and a high degree of capital mobility as well as abstracting from risk it is reasonable to assume that corporations largely face a fixed world-market interest rate plus a risk premium when raising equity capital.<sup>17</sup> In such a setting, differences in the post-corporate income tax rates of return are mainly due to differences in the risk profile of the corporations. Furthermore, under these conditions real investment decisions are not effected by the taxation of shareholders.<sup>18</sup> Hence, ensuring neutrality with respect to the location of investments and the location of (portfolio) investments of individuals constitute two separate issues. Only in cases where domestic equity capital constitutes the marginal source of finance may personal income taxation have an influence on the cost of capital.<sup>19</sup> Hence, efficiency considerations with respect to cross-border portfolio investments should take the after-corporation tax market rate of return as a starting point. Consequentially, with respect to efficiency considerations no point can be made for introducing a full imputation system that fully take into account all levels of corporate income tax.

With respect to efficiency considerations, two prerequisites for eliminating distortions to the decision whether to invest in a domestic or a foreign corporation can now be derived. First of all, the country of residence may not grant more favourable relief for economic double taxation to domestic dividends than to foreign ones. This is also in line with the requirements of European Law highlighted above. Consequentially, the member states are free to choose whether they apply an imputation credit, shareholder relief or exempt dividends as long as domestic dividends are not tax favoured as a consequence. This conclusion is in contrast to the traditional notion of CEN and stems from the assumption that post-corporation tax rates of return are to a large extent equalised worldwide. This reasoning is, however, consistent with the basic perception that the dividend taxation systems applied by the individual member states need to be taken as a starting point and that a harmonisation of the dividend taxation systems is considered to be too far reaching. Secondly, juridical double taxation must be fully eliminated. Otherwise, investors will be deterred from investing abroad. How this can be achieved has been pointed out in the previous chapter. In addition, it has to be kept in mind that even in case withholding taxes are fully credited against the domestic personal income tax liability investors may be deterred from investing in foreign corporations due to cash-flow effects and high compliance costs. Therefore, simplicity considerations are addressed in the following.

### **3.3. Simplicity and enforceability considerations**

In addition to eliminating distortions to investment decisions, efficiency considerations require that cost related to tax compliance and tax planning as well as administrative costs are not disregarded as they also contribute to the excess burden of taxation.<sup>20</sup> Hence, the cross-border taxation of dividends paid to individuals should be as simple as possible in order to promote the efficient allocation of resources.<sup>21</sup> High compliance costs related to foreign investment may render such investments unattractive. In turn, high administrative costs require higher tax rates in order to finance the same amount of public expenditure. This implies that tax law should be enforceable with reasonable effort.

Withholding taxes may help to efficiently enforce a system of worldwide taxation. Complex procedures for treaty relief and the refunding of withholding taxes may, however, significantly increase

---

<sup>17</sup> See Devereux, 2004, p. 82; Devereux, 2008, p. 707; OECD, 2007, p. 69.

<sup>18</sup> See Graetz & Grinberg, 2003, pp. 554 et seq.

<sup>19</sup> See Owens, 2006, p. 158.

<sup>20</sup> See Andreoni et al., 1998, p. 818.

<sup>21</sup> See Spengel & Wendt, 2007, p. 13.

compliance costs. Hence, abolishing withholding taxes may reduce compliance and administrative costs especially in case the country of residence exempts foreign dividends. Moreover automatic information exchange constitutes an alternative for enforcing residence taxation which can make the costs related to levying a withholding tax redundant. Though, no empirical evidence is available on the magnitude of compliance and administrative costs related to the imposition of withholding taxes in comparison to the costs of administrating automatic exchange of information.

### **3.4. Equity considerations**

#### **Individual equity and equality**

The ability to pay principle constitutes a fundamental tax principle in most member states that ensures that individuals are taxed equally. Whether the ability to pay principle and consequentially equal taxation of individuals require that the worldwide income is taxed in the country of residence is disputable. Whereas one strand of literature claims that equal taxation according to the ability to pay principle requires that domestic and foreign income is subject to the same tax burdens,<sup>22</sup> the other argues the opposite or highlight that the ability to pay principle is satisfied by taking foreign income into account within the context of progressive income taxation.<sup>23</sup> For the purpose of this report the decision whether to apply worldwide or territorial taxation is left to the discretion of the individual member states as the domestic tax systems including the choice of dividend taxation system are taken as a starting point of the analysis.

#### **Allocation of taxing rights**

The taxation of cross-border income raises the issue of how to allocate the right to tax the respective income to the source and the residence country. In case the source country levies a withholding tax on dividends, this first of all reduces the after tax return on investment received by the investor. In addition, source taxation results in a revenue loss in case the residence country grants a deduction or a tax credit for the tax levied at source. It is useful to distinguish these two aspects. According to historical practices codified through double taxation conventions, the source country levies corporate income tax on business profits and may, in addition, impose a withholding tax on distributed profits. In case of dividends paid to individual investors, tax treaties generally limit the withholding tax rate is to 15%. In turn, the residence country's right to tax foreign dividends is not restricted. Although the imposition of withholding taxes at limited rates is historical treaty practice it can still be challenged on the grounds of achieving a more persuasive allocation of taxing rights.

Whereas the taxation of proceeds from direct investment in the country of source can be justified by referring to the fact that the source country provides infrastructure, qualified workforce and other public goods that constitute fundamental prerequisites for generating income, the connection to the source country is rather loose with respect to portfolio investments by individuals. Therefore, the rationale for levying withholding taxes on dividends in addition to corporate income tax is not very strong disregarding the fact that levying such taxes constitutes common treaty practice and follows revenue considerations.<sup>24</sup> The recent tendency to lower withholding taxes on dividends received by

---

<sup>22</sup> See Musgrave & Musgrave, 1972, p. 68; Vogel, 1990, p. 124 with further references.

<sup>23</sup> See Kaufman, 1998, p. 173 with further references; Vogel, 1990, p. 158.

<sup>24</sup> See Graetz & Warren, 2007, p. 570; Vann, 2003, p. 49.

individuals on a unilateral basis is in line with this argument.<sup>25</sup> Abolishing withholding taxes on dividends paid to individuals would result in a more clear cut allocation of taxing rights: the right to tax business profits is allocated to the source country whereas the right to tax distributed profits is allocated to the country of residence.<sup>26</sup>

#### **4. Evaluation of possible reform options for the taxation of dividends received by individuals**

In the following, we present our proposal to reform the cross-border taxation of dividends received by individuals. In addition, the options listed in the consultation paper are discussed.

##### **4.1. Abolition of withholding taxes on cross-border dividend payments to individuals with automatic information exchange**

We propose to abolish withholding taxes on dividends received by foreign individuals across Europe by way of a Council Directive.<sup>27</sup> As a consequence, juridical double taxation would be eliminated without having to make reference to the member states' dividend taxation systems. In addition, this would mitigate economic double taxation that results from excess foreign indirect tax credits. In case the residence country exempts dividends, abolishing withholding taxes would fully eliminate economic double taxation. Hence, distortions to the choice whether to invest in the shares of a foreign or a domestic corporation would be eliminated as long as the country of residence treats domestic and foreign dividends equally. Besides removing the extra burden of juridical double taxation, the abolition of withholding taxes also resolves the issue of negative cash-flow effects and compliance costs related to the existence of withholding taxes highlighted in chapter two which may also deter individuals from investing in foreign shares. As a matter of course, abolishing withholding taxes would also resolve existing infringements to the free movement of capital due to the discriminatory imposition and crediting of withholding taxes. We do not propose any further harmonisation of the tax systems of the member states of the EU as we consider this to be infeasible. As pointed out in section 3.2, under the assumption that after-corporate income tax rates of return related to portfolio investments are to a large extent equalised across the member states efficiency considerations do not require that economic double taxation is eliminated. Rather, the country of residence must treat domestic and foreign dividends equally on the grounds of efficiency and neutrality as well as European Law.

The abolition of withholding taxes on dividends has, however, two drawbacks. Firstly, it negatively affects the source country's tax revenue to the benefit of the residence country. Though, as discussed in section 3.4, the source country's claim to tax dividends paid out of profits that have already been subject to corporate income tax is not considered to be very persuasive. Secondly, withholding taxes are often considered to assist in effectively taxing foreign income in the country of residence.<sup>28</sup> Therefore, we propose that automatic information exchange is introduced in turn which is considered to be a more effective mean to encounter tax evasion.<sup>29</sup> Automatic exchange of information with respect to dividends received by individuals may be implemented by extending the scope of the recently released Council Directive 2011/16/EU on the administrative cooperation in the field of

---

<sup>25</sup> See Magliocco & Sanelli, 2009, p. 211; Vann, 2003, p. 51.

<sup>26</sup> See Vann, 2003, p. 53.

<sup>27</sup> This is insofar in line with option one presented in the consultation paper.

<sup>28</sup> See Magliocco & Sanelli, 2009, p. 201 f.

<sup>29</sup> See Council Directive 2011/16 EU.



taxation<sup>30</sup> to cover such dividends. This is in line with the step-by-step approach pursued by the European Commission to generally expand the scope of the directive. In detail, the directive specifies that the European Commission has to present a report and - if required - a proposal until 1<sup>st</sup> of July 2017 concerning the issue of subjecting dividends to automatic exchange of information under the Directive 2011/16/EU. We, however, recommend that this issue is discussed by the European Commission as soon as possible in order to amend the Directive to introduce automatic exchange of information for dividends at the beginning of 2016.

Concerning the implementation of automatic exchange of information, article 20 of the Council Directive 2011/16/EU refers to the procedures set out in the Savings Directive.<sup>31</sup> The automatic exchange of information can be effectively carried out by way of a standard computerised format as SMF or STF developed by the OECD using magnetic media, DVDs or electronic media for the transmission of the data.<sup>32</sup> Analogous to the Savings Directive, the information transmitted by the paying agent should inter alia comprise the identity and the residence of the beneficial owner of a dividend payment as well as the amount of dividends paid. With the growing importance of information exchange, introducing a common taxpayer identification number in the European Union would in addition help rendering information exchange more effective.

Automatic exchange of information has two major drawbacks. Firstly, tax administrations and paying agents have to face significant administrative and compliance costs. Secondly, investors may relocate capital to jurisdictions that do not take part in information exchange in order to circumvent the forwarding of information to their country of residence.<sup>33</sup> As a consequence, introducing automatic exchange of information to enforce residence taxation is only to some extent effective. The first issue may be addressed by using standardised forms, formats and channels of communication for all categories of income that are subject to information exchange. In doing so, the costs related to automatic exchange of information can be limited to a reasonable percentage of tax revenue. The second issue requires that the scope of automatic exchange of information is expanded to Non-EU-countries that currently serve as important financial centres for investments by EU-residents. Therefore, equivalent measures need to be negotiated with important third countries as Liechtenstein or Switzerland in order to mitigate the risk that the introduction of automatic exchange of information will result in a migration of deposits in shares. Though, most financial centres have strict bank secrecy laws which may render it difficult or even impossible to provide the required information on an automatic basis. This applies inter alia to Austria, Belgium, Luxemburg, Liechtenstein and Switzerland.

As the Savings Directive is faced with the same issues, it provides for transitory provisions that allow the above named member states to impose anonymous withholding taxes on interest received by EU-residents instead of automatic exchange of information. Moreover, comparable agreements have been reached with Liechtenstein, Switzerland and other countries as well as territories of EU-members. The applicable withholding tax rate will be increased to 35% on the 1<sup>st</sup> of July 2011. As 75% of the tax revenue is transferred to the country of residence, this helps ensuring that the country of residence raises a significant amount of tax revenue from foreign savings. This approach therefore constitutes a sensible alternative in case certain member states and Non-EU-countries do not ap-

---

<sup>30</sup> Council Directive 2011/16/EU.

<sup>31</sup> See Council Directive 2003/48/EC.

<sup>32</sup> See OECD, 2006, p. 3, 5, 62.

<sup>33</sup> See Keen & Lighthart, 2006, p. 89.

prove of automatic exchange of information with respect to dividends. Though, the issue of third countries remains with respect to important financial centres outside of Europe as Hong Kong and Singapore. Therefore, effectively enforcing the automatic exchange of information with respect to dividends received by individual investors resident in the EU member states constitutes a challenging goal which is worth pursuing.

## **4.2. Assessment of the options disclosed in the consultation paper**

### **4.2.1. Options that primarily address the issue of juridical double taxation**

The imposition of withholding taxes may result in juridical double taxation because foreign direct tax credits are usually limited to the domestic tax burden related to the foreign income. The foreign withholding tax levied at source may exceed the domestic tax because the withholding tax rate is comparably high or due to the fact that it is imposed on gross dividends whereas personal income tax is determined on a net basis. Consequentially, five options can be derived to eliminate or mitigate the issue of juridical double taxation:

1. to abolish withholding taxes altogether,
2. to introduce full tax credits in the residence country,
- 3a. to levy withholding taxes on a net basis,
- 3b. to tax dividends in the country of residence at a gross basis, and finally
4. to significantly reduce withholding tax rates.

In the following, these options which are also presented in the consultation paper – with the exception of proposition 3b<sup>34</sup> – are briefly discussed by way of referring to the criteria presented in chapter three.

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

This option differs from the proposal presented in section 4.1 in so far as it does not provide for the introduction of automatic exchange of information in order to assume the role of withholding taxes in enforcing residence taxation of dividends. The sole abolition of withholding taxes has the advantage of avoiding the tax administration costs and the compliance costs of the paying agents related to implementing and administering the automatic exchange of information. Though, this may render the effective taxation of foreign income in the country of residence difficult, result in an increase of tax evasion and consequentially a revenue loss. In case investors may avoid taxes by investing abroad, the efficient allocation of portfolio equity capital would be distorted and as a consequence the positive efficiency and neutrality characteristics of abolishing withholding taxes might be offset. We therefore do not propose to abolish withholding taxes without expanding the scope of automatic exchange of information to dividends.

---

<sup>34</sup> Option 3b which aligns the determination of withholding taxes and personal income taxes by way of levying personal income taxes on a gross basis is discussed for the sake of completeness.

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

To address the issue of excess foreign direct tax credits, this option involves that the residence country grants a full tax credit for withholding taxes levied at source. This implies that the country of residence even offsets the tax credit for foreign withholding taxes from personal income tax related to other categories of income in case the personal income tax related to foreign dividends is not sufficiently high. As a consequence, juridical double taxation is fully eliminated. We, however, consider this option not to be feasible due to the following two issues. First, introducing full tax credits for withholding taxes levied at source constitutes a far reaching interference with national tax systems. Second, this proposition would result in a revenue loss for residence countries that currently exempt dividends or apply comparably low personal tax rates.

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

The issue of excess foreign tax credits may also be addressed by imposing withholding taxes on a net basis. This requires that the withholding tax levied at source is determined by taking into account personal allowances and deductions which are traditionally only available for investors resident in the country of source when determining the personal income tax liability. As a consequence, foreign and domestic investors would be treated equally from the perspective of the source country thereby ensuring conformity with European Law. As this procedure would result in a lower withholding tax burden, the risk of excess foreign tax credits and hence juridical double taxation would additionally be mitigated. As long as the country of residence treats domestic and foreign dividends equally, the decision whether to invest in a domestic or a foreign corporation will not be distorted. Levying withholding taxes on a net basis, however, would result in a revenue loss for the source country whereas some residence countries would generate additional revenue as they have to provide lower tax credits due to the reduced withholding tax burdens. This affects the allocation of taxing rights. Though, the source countries claim to tax dividends paid to foreign investors is not considered to be very persuasive as pointed out in section 3.4. Introducing the net principle for determining the withholding tax burden at source has, however, one major drawback. It will render the taxation of dividends at source much more complex and consequentially increase tax administration costs. We therefore do not consider this option to be a suitable solution for addressing the issues of cross-border taxation of dividends received by individuals.

## **Option 3b: Gross rather than net taxation in the residence Member State**

In contrast to determining withholding taxes levied at source on a net basis, the taxation in the country of residence and the source country may also be aligned by taxing dividends on gross basis. This involves that the country of residence does not prove any personal allowances and the deduction of expenses related to dividends. Presently, many member states already apply flat taxes to dividend income. But, this usually only involves that no deductions are available, whereas most member states still provide tax exempt amounts. This proposal would require that the member states change their domestic tax systems. This is in contrast to the fundamental perception highlighted earlier that domestic tax systems should be taken for granted as a comprehensive harmonisation of national tax systems is considered to be infeasible. We therefore do not promote this proposal.

#### **Option 4: Application of a general EU-wide reduced rate of withholding tax with information exchange**

Finally, juridical double taxation resulting from excess foreign tax credits may be mitigated or even prevented by reducing withholding taxes. This may be accomplished by introducing a general EU-wide withholding tax rate on dividends received by individuals by way of a Council Directive. In order to fully eliminate the risk of juridical double taxation, the withholding tax rate would have to undercut all personal income tax rates applied to dividends in the member states of the European Union. In addition, the rate must be low enough to account for differences in the tax burdens due to the fact that the personal income taxes are determined on a net basis. As a consequence, the source country would face a loss of tax revenue whereas the residence countries would be able to generate additional tax revenue as they can tax a higher share of foreign income due to lower tax credits.

In order to ensure that residence taxation is effectively enforced, the introduction of a reduced withholding tax rate can be accompanied by introducing exchange of information. Alternatively, taxpayers may be granted the option to either benefit from the reduced tax rate under the condition of exchange of information or to be taxed at a higher rate without exchange of information. A comparable strategy is already pursued with respect to interest income received by individuals through the Savings directive. This option in so far corresponds to the proposal we present in section 4.1 as the scope of the exchange of information is expanded to dividends. Though, to maintain withholding taxes in addition to information exchange - even at a low level - causes additional compliance and administrative cost compared to a cross-border tax system that solely relies on automatic exchange of information. From the perspective of efficiency and simplicity considerations we therefore consider this option to be less suitable to address the shortcomings of the cross-border taxation of dividends received by individuals. As pointed out in chapter 4.1 the imposition of an anonymous withholding tax rate at comparably high rates might, however, constitute an alternative for implementing automatic exchange of information for those member states and third countries that are reluctant to provide information on a constant basis. Therefore, the introduction of transitory provisions comparable to those provided by article 11 of the Savings Directive might be sensible.

#### **4.2.2. Options that address both economic and juridical double taxation**

The options discussed so far primarily address the issue of juridical double taxation. Abolishing withholding taxes or reducing withholding tax rates may also contribute to eliminate economic double taxation, but only in case the country of residence exempts dividends from personal income tax. In the following, two proposals are addressed that also explicitly deal with the problem of economic double taxation.

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

By limiting the withholding tax rate applied at source, juridical double taxation can be mitigated or even eliminated. Such a reduction in tax rates can either be accomplished on a unilateral or a bilateral basis or by way of a Council Directive, whereas the last approach constitutes the most reliable one. If the residence country in addition exempts dividends or grants an indirect tax credit for underlying corporate income the issue of economic double taxation can also be resolved. Though, foreign tax credits –whether indirect or direct - are usually limited to the domestic income tax liability. But, in case the withholding tax rates are reduced in the source country, the country of residence can

provide a higher indirect tax credit given the same amount of tax revenue from foreign income. These positive effects with respect to double taxation, however, are at the expense of tax revenue. The source country faces a revenue loss due to the withholding tax rate reduction. Concerning the country of residence, the tax revenue effects depend on the level of the indirect tax credit.

Though, it has to be kept in mind that the vast majority of EU member states currently applies shareholder relief or classical tax systems. Member states that have applied imputation systems in the past have moved towards other kinds of dividend taxation systems as they were not willing to expand the scope of imputation systems to foreign dividends as required by European Law.<sup>35</sup> Therefore, we do not consider this proposal to be enforceable. Rather, the choice of dividend taxation system should be left to the individual member states. Furthermore, it is not required in order to eliminate distortions to the choice whether to invest in domestic or foreign corporations as pointed out in section 3.1.

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

One approach to fully eliminate juridical as well as economic double taxation is to abolish withholding taxes levied at source as well as to exempt dividends from personal income tax in the country of residence. As a consequence, business profits are subject to only one level of taxation, namely corporate income tax levied by the country of source. Moreover, compliance and administrative costs related to the imposition of withholding taxes and residence taxation of dividends would be prevented. Assuming that the post-corporate income tax rates of return related portfolio equity investments are to a large extent equalised across the EU as described in section 3.2, the efficient allocation of equity capital would furthermore not be distorted by taxation.

One major drawback of this proposal is its negative effect on tax revenue. Both the source and the residence country would have to face losses in tax revenue. Moreover, in order to treat domestic and foreign dividends equally, the exemption would have to be applied to all dividends resulting in an even higher revenue loss for the country of residence. An equal treatment of domestic and foreign dividends may be required by individual equity considerations as described in section 3.4. Furthermore, this proposal would require a significant harmonisation of national tax systems. This is, however, not considered to be feasible as highlighted in chapter two. We therefore do not propose to accompany the abolition of withholding taxes by introducing an EU-wide exemption of foreign dividends.

#### **4.2.3. Interim conclusion**

The options presented in the consultation paper constitute very different approaches to address the shortcomings of cross-border taxation of dividends received by individuals, namely the issues of double taxation and the discriminatory imposition and crediting of withholding taxes. They, however, all have several weaknesses that the proposal we present in section 4.1 aims to avoid. Hence, our proposal combines sensible elements of the options presented in the consultation paper: the abolition of withholding taxes imposed on dividends received by individuals and the implementation of automatic exchange of information with respect to such dividends.

---

<sup>35</sup> See Graetz & Waren, 2006, p. 1211 f.

## **5. Conclusion**

The cross-border taxation of dividends received by individuals has several shortcomings. Juridical double taxation as well as the discriminatory crediting of withholding taxes in the country of residence may deter individuals from investing in foreign corporations. Moreover, the imposition of withholding taxes on dividends results in negative cash-flow effects as well as administrative and compliance costs. Consequentially, the cross-border taxation of dividends received by individuals has to be revised.

Possible reform options have to meet several criteria. Efficiency and neutrality constitute fundamental aims of tax policy. In addition, tax provisions should be as simple as possible as well as enforceable with reasonable effort. Moreover, the tax law must be in line with the requirements of European Law. Finally, individual equity considerations and effects on the allocation of taxing rights between the source and the residence country as well as on tax revenue have to be taken into account.

In order to deal with the shortcomings pointed out above, we propose to abolish withholding taxes on dividends received by individuals by way of a Council Directive. To ensure the effective taxation of foreign dividends in the country of residence we furthermore propose that automatic exchange of information is introduced with respect to dividends received by individuals. This can be achieved by expanding the scope of Directive 2011/16/EU accordingly.

The analysis of the alternative options presented in the consultation paper reveals several weaknesses which our own proposal aims to avoid. Therefore, our proposal combines sensible elements of the reform options listed in the consultation paper. These are the abolition of withholding taxes levied on dividends received by individuals and the implementation of automatic exchange of information concerning such dividends.

## Bibliography

Andreoni, James; Erard, Brian; Feinstein, Jonathan (1998): Tax Compliance, in: *Journal of Economic Literature* 36(2), pp. 818-860.

Devereux, Michael P. (2000): Issues in the taxation of income from foreign portfolio and direct investment, in: Cnossen, Sijbren (ed.): *Taxing capital income in the European Union*, pp. 110-131.

Devereux, Michael P. (2004): Debating Proposed Reforms of the Taxation of Corporate Income in the European Union, in: *International Tax and Public Finance* 11(1), pp. 71–89.

Devereux, Michael P. (2008): Taxation of outbound direct investment: economic principles and tax policy considerations, in: *Oxford Review of Economic Policy* 24(4), pp. 698–719.

Englisch, Joachim (2010): Taxation of Cross-Border Dividends and EC Fundamental Freedoms, *Intertax* 38(4), pp. 197-221.

European Commission (2001): *Company Taxation in the Internal Market*, Brussels.

European Commission (2003): *Communication from the Commission to the Council, The European Parliament and the European Economic and Social Committee - Dividend taxation of individuals in the Internal Market*, 2003(COM) 810, Brussels.

Graetz, Michael J.; Grinberg, Itai (2003): Taxing International Portfolio Income, in: *Tax Law Review* 53, pp. 537-586.

Graetz, Michael J.; Warren, Alvin C. (2006): Income tax discrimination and the political and economic integration of Europe, in: *Yale Law Journal* 115(6), pp. 1186-1255.

Graetz, Michael J.; Warren, Alvin C. (2007): Dividend Taxation in Europe: when the ECJ makes Tax Policy, in: *Common Market Law Review* 44(6): pp. 1577–1623.

Griffith, Rachel; Hines, James; Sørensen, Peter B. (2010): International Capital Taxation, in: Mirlees, James A.; Adam, Stuart (eds.): *Dimensions of tax design – The Mirlees Review*, pp. 914-1027.

Keen, Michael; Ligthart, Jenny E. (2006): Information Sharing and International Taxation: A Primer, in: *International Tax and Public Finance*, 13(1), pp. 81–110.

Kaufman, Nancy H. (1998): Fairness and the Taxation of International Income, in: *Law and Policy in International Business* 29(1), pp. 145-203.

Magliocco, Antonella; Sanelli, Alessandra (2009): Should outbound dividends remain taxat at source in the European Union? Some hints from the Italian example, in: *European Taxation* 4(4), pp. 199-214.

Musgrave, Richard; Musgrave, Peggy B. (1972): Inter-nation equity, in: Bied, Richard M.; Head, John G. (eds.): *Modem Fiscal Issues: Essays in Honor of Earl S. Shoup*, Toronto, pp. 63-85.

OECD (2006): *Manual on the implementation of exchange of information provisions for tax purposes, module 3 on automatic (or routine) exchange of information*.

OECD (2007): *Fundamental Reform of Corporate Income Tax*, OECD Tax Policy Studies No. 16, Paris.

Owens, Jeffrey (2006): Fundamental Tax Reform: An international perspective, in: National Tax Journal 59(1), pp. 131-164.

Schön, Wolfgang (2009): International Tax Coordination for a Second-Best World, in: World Tax Journal 1(1), pp. 67-114.

Spengel, Christoph; Wendt, Carsten (2007): A Common Consolidated Corporate Tax Base for Multinational Companies in the European Union: some issues and options, Oxford University Centre for Business Taxation WP 07/17, Oxford.

Vann, Richard J. (2003): General Report, in: IFA Cahiers de droit fiscal international, Vol. 88a, pp. 21-70.