ISSN 1725-7557

European Commission — Taxation and customs union

Taxation papers

A history of the "tax package"
The principles and issues underlying the community approach

WORKING PAPER
NO 10 – 2006

KP-AC-06-010-EN-C

ISBN 92-79-02181-8

Publications Office
Publications.europa.eu

Comments and inquiries should be addressed to:

TAXUD---TAXATION-PAPERS@cec.eu.int

Cover photo made by Milan Pein
Despite all our efforts, we have not yet succeeded in identifying the authors and rights holders for some of the images. If you believe that you may be a rights holder, we invite you to contact the Central Audiovisual Library of the European Commission.

Doc. TAXUD/2007/2901 - EN
This paper is available in English only

Cataloguing data can be found at the end of this publication.

Luxembourg: Office for Official Publications of the European Communities, 2007

ISBN 92-79-02181-8

Printed in Italy

PRINTED ON WHITE CHLORINE-FREE PAPER

European Commission

Taxations Papers — A history of the "tax package".
The principles and issues underlying the community approach

Luxembourg: Office for Official Publications of the European Communities

2006 – 27 pp. – 21 x 29.7 cm

ISBN 92-79-02181-8

TAXATION PAPERS

A history of the "Tax Package"
The principles and issues underlying the Community approach

by

Philippe Cattoir

Working paper No 10 – December 2006

Executive summary

This article presents an overview of the EU "Tax Package", comprising the Code of Conduct for business taxation, the Directive on taxation of savings income and the Directive on taxation of interest and royalty payments. Its main objective is to offer a comprehensive view of the negotiation process, and a broad overview of the content of the package, as well as pending policy issues. This then allows drawing a number of lessons concerning the approach followed and the outlook for future European initiatives on direct taxation.

An agreement on the Tax Package was obtained in June 2003 following several years of intense negotiation between the EU Member States. This outcome was attributable to an innovative tax strategy, which involved bundling a number of sensitive issues so that every Member State could be an overall winner.

The negotiations on the Tax Package highlighted the global dimension of tax issues. It could never have been concluded without the agreement of certain key third countries and dependent or associated territories of Member States. The tax debate thereby led to discussions on other aspects of the EU's relations with the countries or territories concerned. Were action against harmful practices to be stepped up in the future, the EU's Member States and institutions might consider explicitly linking the abolition of harmful tax practices to other issues.

Looking beyond the Tax Package, the EU will have to make a number of strategic choices in tax matters. The Community's field of intervention in matters of harmful tax competition could for instance be expanded to encompass additional forms of competition to those covered by the Tax Package.

Decision-making processes and "institutions" are also an important issue. In particular, an issue is whether to foster the existence of a loose negotiating structure based on a body of high-level working groups or to try and integrate these working groups into a more stable and coherent framework such as a EU Tax Policy Committee.

The Tax Package has brought major advances in matters of tax policy at EU level. Besides stimulating thought and discussion on tax competition, it has raised awareness among the Member States of the interdependence of their tax policies and of the potential benefits of cooperation at EU level.

JEL Classification: H30

Keywords: EU tax policy - EU tax package - savings directive - code of conduct for business taxation - Taxation Policy Group

A HISTORY OF THE "TAX PACKAGE"
THE PRINCIPLES AND ISSUES UNDERLYING THE COMMUNITY APPROACH

Philippe Cattoir [1]

"*Start out with an ideal and end up with a deal*"
K. Albrecht

Introduction

Decision-taking in the taxation area at EU level is notoriously difficult. Taxation is at the heart of national sovereignty and one of the most protected "*chasses gardées*" of the EU Member States. Unanimous decisions on tax matters between the latter are therefore generally only obtained after long and difficult negotiations.

Therefore, a recurring question arises as to how cooperation between Member States can be nurtured when need for such cooperation is identified.

An interesting answer was found in the last decade with the development of a "package approach" in order to solve some of the most pressing EU issues in the direct taxation area. Between 1997 and 2004 the Ministers of Economy and Finance of the EU Member States devoted considerable efforts in order to adopt the Tax Package, comprising the Code of Conduct for business taxation, the Directive on taxation of savings income and the Directive on taxation of interest and royalty payments.

This article presents an overview of this Tax Package. Its main objective is to offer a comprehensive view of the negotiation process, and a broad overview of the content of the package, as well as pending policy issues. This then allows drawing a number of lessons concerning the approach followed and the outlook for future European initiatives on direct taxation.

The first section chronicles discussions in the Council and their final outcome. It deals with each of the Tax Package's three components in turn. It describes in detail the objective set by the Council, the working method followed and the outcome of negotiations. The second section presents recent developments in the three areas included in the Tax Package. It also discusses policy issues and presents some ideas of potential future developments in these areas. The third section offers a few thoughts on the "package approach" decided in Verona. Beyond the tax package, it presents a reflection on EU decision-taking processes and instruments in the tax area.

---

[1] The author is administrator at the European Commission Directorate-General for Budget. This paper stems in part from several previous works in collaboration with former colleagues in the Commission Directorate-General for Taxation in Customs Union, whom I thank here. I would like to acknowledge in particular inputs and comments from M. Mors (sections 1 and 3), V. Kalloe and J.-E. Dulière (Code of Conduct), G. Mirabile (Savings Directive), U. Ihli (Interest and royalties). Remaining mistakes are the sole responsibility of the author, though. The opinions expressed in this article do not necessarily reflect the views of the European Commission. Contact: philippe.cattoir@ec.europa.eu.

1. A history of the "Tax Package"

Before turning to the detailed description of negotiations for each of the components of the Tax Package, it is worth setting the scene by briefly recalling some elements of context and providing a quick overview of the Verona approach.

Direct taxation is an area in which cooperation at EU level is notoriously difficult. Owing to the need for unanimity, it took, for instance, almost 30 years of discussions[2] to produce the first European directives on business taxation, the 1990 Parent/Subsidiary and Merger Directives.[3]

In response to the growing need for international cooperation on direct taxation and the sheer difficulty of meeting that need, notably because such decisions have to be unanimous, the Commission[4] prompted a general discussion of taxation in the EU when Ecofin met informally in Verona in April 1996. This discussion brought progress on two fronts. First, a high-level working group was set up to address tax issues at EU level: it comprised personal representatives of the finance ministers and was chaired by the competent member of the Commission.[5] This working group was to foster more direct, less bureaucratic and less formal contacts between the finance ministers' personal representatives and to give tax discussions in the EU a more political dimension. In terms of content, the Verona Council marked the beginning of an EU tax strategy based on a comprehensive approach, on the simultaneous and linked discussion of a number of important issues.

The work carried out by the Commission[6] in liaison with the high-level working group (which became the Taxation Policy Group in December 1996[7]) after the Verona Council culminated in the adoption of a Tax Package at the Council meeting of 1 December 1997. The package was expressly linked to the Verona discussions and explained by "*the need for coordinated action at European level to tackle harmful tax competition in order to help achieve certain objectives such as reducing the continuing distortions in the single market, preventing excessive losses of tax revenue or getting tax structures to develop in a more employment-friendly way.*"[8] These objectives were related in practice, since most Member States were unwilling to put their weight behind a measure aimed at reducing tax distortions in the single market and to getting tax structures to develop in a more employment-friendly way without firm guarantees that their tax revenue would not fall.

---

2 In the wake of the Neumark report proposing the harmonisation of business taxation in the Community, *Europäische Wirtschaftgemeinschaft – Kommission: Bericht des Steuer- und Finanzausschusses (Neumark Bericht)*, Brussels, 1962.

3 These Directives (90/435/EEC and 90/434/EEC respectively) were the result of proposals that had been on the Council table since 1969 (see OJ C 39, 22.3.1969).

4 *Taxation in the EU*, European Commission, 1996.

5 Mario Monti, succeeded in autumn 1999 by Frits Bolkestein.

6 See *Taxation in the EU: report on the development of tax systems*, European Commission, 1996; *Towards tax co-ordination in the EU: a package to handle harmful tax competition*, European Commission, 1 October 1997; *A package to tackle harmful tax competition in the EU*, European Commission, 5 November 1997.

7 Dublin European Council.

8 Ecofin meeting of 1 December 1997. Note that there is no precise definition of harmful tax competition. There are, however, a number of criteria for identifying harmful measures by their supposed impact on the single market, tax revenue and employment.

"*In a spirit of comprehensiveness of approach*" – vital to achieving a unanimous agreement - three areas of direct taxation[9] were highlighted: (i) business taxation, (ii) taxation of savings income and (iii) the issue of withholding taxes on cross-border interest and royalty payments between companies. A code of conduct was proposed for business taxation, and the Commission was asked to submit proposals for directives in the other two areas and to pursue its work on taxation with the Taxation Policy Group. The issues, the arguments and the negotiating methods are explained below.

A systematic examination of the discussions relating to the Tax Package reveals the incremental nature of the negotiating process. The discussions and diagnosis that culminated in the Verona Council were followed, as of 1 December 1997, by more or less separate discussions in each of the three areas of the Tax Package. Specific procedures and negotiating bodies were set up for each area. The treatment of each area in isolation showed its limitations at the Helsinki European Council of 10 and 11 December 1999, where savings brought everything to a halt. This European Council was therefore followed by a period of hesitance and uncertainty while all political efforts were focused on finding a way out of the deadlock. A solution was reached at the Santa Maria da Feira European Council of 19 and 20 June 2000 in the form of a political compromise on savings. This breathed new life into the Tax Package, resulting in an intermediate agreement at the Ecofin meeting of 26 and 27 November 2000.[10] The content of the Tax Package was basically wrapped up at the end of 2000, but the same measures still had to be accepted by a number of dependent or associated territories and equivalent measures in non-member countries. Most of these negotiations were completed towards the end of 2004.

1.1. The Code of Conduct for Business Taxation

Aims

The Code "*concerns those measures which affect, or may affect, in a significant way the location of business in the Community*". More specifically, "*tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this Code. Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any other relevant factor.*"

The Code also lays down criteria for assessing harmful tax measures:

"*When assessing whether such measures are harmful, account should be taken of, inter alia:*
i. whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or

---

9 There had initially been plans to include indirect taxation in the package. In the face of opposition from several Member States at the Ecofin meeting on 13 October, the Commission dropped indirect taxation from subsequent versions of the package.

10 Discussions between The European Council of Santa Maria da Feira and the European Council in Nice (8/12/2000) were conducted by the Code of Conduct Group (Business Taxation) and the Financial Questions Group (savings, interest payments and royalties).

ii. whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base, or
iii. whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages, or
iv. whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD, or
v. whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way."

It should be stressed that the assessment of whether tax measures are harmful under the Code of Conduct was based on clear criteria (which nevertheless left room for interpretation) and confined to specific measures in Member States' tax systems. There was absolutely no question of using the Code as a basis for assessing general tax measures. The "harmfulness" of measures was also based on criteria which, though heading in the same direction, differ slightly from those of other international forums, and in particular the OECD.[11]

<u>Method</u>

The Code of Conduct provided for the Council to set up a group to assess the tax measures that could fall within the scope of the Code. The setting-up of the group was confirmed at the Ecofin meeting of 9 March 1998. It was called the "Code of Conduct Group" or the "Primarolo Group", after its chair, Ms Dawn Primarolo, the current Paymaster-General of the United Kingdom. At the time of publication of this article, the Code of Conduct Group continues to monitor the standstill and rollback of harmful tax measures.

It is worth recapitulating the working method used. First and foremost, the fact that the Code of Conduct "*is a political commitment and does not affect the Member States' rights and obligations or the respective spheres of competence of the Member States and the Community resulting from the Treaty"* makes clear the Council's desire to keep control of work relating to the Code. The leading role in the negotiations was therefore played by the Code of Conduct Group, whose secretariat is officially provided by the Council's General Secretariat. The Commission admittedly plays a major role via its support to the Group and its participation in the Group's discussions – indeed it has drawn up almost all of the Group's key working papers – but the working environment remains heavily intergovernmental. This is illustrated beautifully by the Code of Conduct's inclusion in a "*Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation*".

Though the Council takes its decisions unanimously, for instance when called on to approve the Group's proposals, the Group itself tends to reach decisions by consensus. The Primarolo Report emphasises that "*where unanimity was not achieved*

[11] For a comparison of OECD and EU criteria, see, for example, *Tax competition in the EU*, European Parliament, Directorate-General for Research, Economic Affairs Series, ECON-105 EN Rec (10-2000).

the report reflects the broad consensus and alternative views."[12] This is in line with the Group's mandate from Ecofin, which requires the Group's reports to the Council to reflect either the unanimous opinion of its members or the different opinions expressed in the course of its discussions. This approach may have been necessary for calm scrutiny of harmful tax measures, but it was certainly not sufficient to enable the Council to (unanimously) agree on the list of 66 measures, presented in the November 1999 report, that "*affect to a significant extent the location of business activity in the European Community*."[13] Ecofin did not manage to reach unanimous agreement on the 66 harmful measures identified by the Primarolo Report until the Council meeting of 26 and 27 November 2000.

Lastly, the Code of Conduct Group's work was, to a certain extent, informed by the Commission's policy on state aids. Note in this respect Ecofin's conclusions of 1 December 1997, in which "*the Council notes that the Commission [...] commits itself to the strict application of the aid rules concerned, taking into account, inter alia, the negative effects of aid that are brought to light in the application of this code.*"[14]

Outcome

Basically, the deadlines for the Code of Conduct's application were agreed in two steps. In November 2000 Ecofin established the key principles for dismantling the 66 harmful measures cited in the Primarolo Report.[15] Generally speaking, all harmful arrangements were to be dismantled by 31 December 2002, as agreed at the Council meeting of 1 December 1997. However, for undertakings deriving benefit from harmful arrangements on 31 December 2000, such arrangements were to lapse no later than 31 December 2005, whether or not they were granted for a fixed period. Undertakings were also "*barred from entering into harmful arrangements after 31 December 2001, except where such arrangements are the subject of an existing Commission decision providing for longer duration within the framework of State aids, and, in any case, from deriving benefit from them after 31 December 2002*". Lastly, the conclusions of November 2000 stated that the Council could nevertheless decide "*on a case-by-case basis, to take account of special circumstances, on the basis of a report by the Code of Conduct Evaluation Group, to continue the effects of certain harmful arrangements after 31 December 2005.*"

However, the relatively tight deadlines fixed at that time for the standstill and rollback of arrangements was out of synch with the slower progress on savings. Some Member

---

12 The Primarolo Report was submitted by the Code of Conduct Group (Business Taxation) to Ecofin on 29 November 1999 (made public after the Ecofin meeting of 28 February 2000).

13 The Primarolo Report lists 201 measures by Member States and 85 by dependent or associated territories that it examined. Many different opinions were expressed by the Member States in the course of discussions. These opinions are mentioned in the report.

14 The Commission has also published guidelines on the application of the rules on state aid to measures relating to direct business taxation (see paragraph J of the Code of Conduct (Business Taxation)). These guidelines were adopted by the Commission on 11 November 1998 (see note 98/C 384/03, OJ No C 384, 10.12.1998, p. 3). See also *Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation* (C(2004)434 of 9 February 2004).

15 See the Presidency's note (13555/00 FISC 190) of 20 November 2000 and Ecofin's conclusions of 26 and 27 November 2000.

States were reluctant to meet the deadlines laid down by the Code when final agreement had yet to be reached on savings. In practice, the standstill on harmful measures was applied by all Member States but not by all their dependent and associated territories. This did not, however, prevent the Code of Conduct Group from making further headway. On a technical level, the Group produced guidelines and did a lot of ground work in a number of problem areas.[16] Further political agreement was reached at the Council meeting of 3 June 2003, this time taking account of much fuller information on the progress achieved in relation to the Directive on savings income, especially in respect of dependent or associated territories and of certain non-member countries. It was decided at that meeting, in line with the possibility afforded by the November 2000 agreement, to extend "*on a case-by-case basis, ... to take account of special circumstances*" the application of certain harmful measures.[17] Some might see this decision as circumstantial evidence – there being no absolute proof – that the agreement on savings was obtained at the cost of greater flexibility on business taxation. The Code of Conduct Group has since pressed on with its work on the standstill and rollback of harmful arrangements. Dozens of the harmful arrangements on the Primarolo Report's list of 66 measures were rolled back in 2003 and 2004. The standstill issue has come up a number of times, and the results have been broadly satisfactory.[18]

It is also worth noting that the commitment to apply the principles of the Code of Conduct figured among the conditions for EU membership in the last (2004) enlargement round. The European Commission screened the candidate countries for potentially harmful measures in 2002-2003 and identified 30. They were discussed by the Council and included in the accession negotiations. The Commission monitored progress and incorporated its findings in the "comprehensive monitoring report on preparations for membership" drawn up for each of the candidate countries. The process proved successful, since the candidate countries had abolished most of the harmful arrangements before enlargement.[19] The standstill and rollback of the new Member States' harmful arrangements is now monitored by the Code of Conduct Group.

Looking at the work done by the Code of Conduct Group it seems fair to say that most of the preferential regimes targeted had one or more of the following features: offshore activities, holding of shares, mobile activities within Free Zones, rulings with a fixed margin and discretionary powers for tax authorities to determine a lower level of taxation than the general applicable rule. Relating to multinational groups, many regimes provided for a preferential treatment (either through a reduced tax rate or a reduced tax base) of financial services, group financing, licensing of patents and trademarks, (captive) insurance and so on.

[16] The Group drew up guidelines for standstill and rollback in the finance branch, holdings and headquarters areas and for transparency and the exchange of information on transfer pricing.

[17] In practice the Council accepted all 18 demands made by the Member States.

[18] In particular, two arrangements introduced by the Netherlands Antilles are to be rolled back on the basis of an agreement reached at the Ecofin meeting of 7 December 2004.

[19] At the time of writing (late 2004), two harmful tax arrangements in one Member State have yet to be abolished, and one arrangement in another Member State may pose a few problems.

1.2. The taxation of savings

Aims

At its meeting of 1 December 1997, the Council laid down, alongside the Code of Conduct for business taxation, the broad principles that "*might form a basis*" for a Council Directive on the taxation of savings income. These principles, which are outlined below, led, on 20 May 1998, to a Commission proposal for a Directive and intensive negotiations, which, for the most part, came to fruition in June 2003.[20] The mandate from the Council stated that "*the scope of such a directive could be limited to interest paid in one Member State to individuals who are resident in another Member State.*" Though identifying an individual's place of residence proved relatively unproblematic, compared with the other issues raised by the political agreement, the same cannot be said of the definition of "interest". The problem is that a number of financial products, and in particular those proposed by collective investment undertakings (CIUs), combine interest income, which is covered by the Directive, with income such as capital gains, which are not.

The Council also suggested that "*as a first step towards effective taxation of savings income throughout the Community, such a directive could be based on the "coexistence model", under which each Member State would either operate a withholding tax or provide information on savings income to other Member States*". This model was intended to take account of each Member State's circumstances, and in particular Luxembourg and Austria's rules on banking secrecy, which made the exchange of information harder to apply than a withholding tax. However, such a model also meant that two residents of a given Member State could, if interest was not spontaneously declared in their Member State of residence, find themselves paying different amounts of income tax on a given financial investment according to the place of collection of the interest. The coexistence model would not therefore be conducive to the optimal allocation of capital in the Community territory[21]. Furthermore, countries applying withholding tax could receive both information concerning their residents abroad and a share of the withholding tax paid by nationals of other Member States resident in their territory. This would give them a disproportionate share of the revenue generated by the taxation of savings income. Lastly, some preferred the exchange of information to withholding tax because it enabled them to levy tax at the marginal rate for all taxpayers, with income from abroad being treated in the same way as domestic income when determining the rate of taxation.

The Council also stressed "*the need to preserve the competitiveness of European financial markets on a global scale*", which made it "*advisable for the points set out above to be adopted as widely as possible. To this end, Member States should undertake to promote the establishment of equivalent measures in third countries* [and in their dependent or associated territories], *at the same time as discussions on the Directive are taking place*". Confining measures on savings to the Member States alone risked causing considerable capital flight from the Community.

---

[20] See COM(1998)295. This proposal for a Directive followed up and replaced a proposal first tabled by the Commission in 1989, fixing a 15% withholding tax on income from interest payments [COM(1989)60].

[21] Absence of capital import neutrality.

Method

Unlike the arrangements made for the Code of Conduct, the procedure used for savings taxation was, at least to begin with, the traditional "Community" approach: the Commission tabled a proposal for a Directive, which was then discussed by a Council working group; the results of these negotiations were regularly forwarded to Ecofin by the Committee of Permanent Representatives (Coreper).

However, owing to the highly political nature of savings taxation and the failure of the negotiations at the Helsinki European Council, it was agreed that a high-level working group would consider specifically how measures to tax savings might be implemented most effectively.[22] Quite separate from the Code of Conduct Group and the Taxation Policy Group, this working group depends directly on the Council.[23] The underlying idea was, as it were, to cut out the middlemen – the Council's technical working group on tax issues and, to a certain extent, Coreper – to address this sensitive issue at a high level from the very outset and so break the stalemate.

Outcome

The Directive on the taxation of savings income was adopted only after a series of partial political agreements and major external negotiations. After a stalemate at the Helsinki European Council, the Santa Maria da Feira European Council of 19 and 20 June 2000 established a number of basic principles for taxing savings with the adoption of a report from Ecofin.[24] Santa Maria da Feira enshrined the primacy of a strategy based on the exchange of information on cross-border interest payments, though a limited number of Member States would be allowed to apply a withholding tax for a transition period. These principles were fine-tuned at Ecofin's meeting of 26 and 27 November 2000 and led, on 18 July 2001, to a new proposal for a Directive from the Commission.[25] Political agreement was reached at Ecofin's meeting of 21 January 2003, and the Directive was formally adopted on 3 June 2003 as part of an overall agreement on the Tax Package. However, the conclusions of the Santa Maria da Feira European Council made the Directive's application conditional on sufficient assurances that equivalent measures would be adopted in six non-member countries (United States, Switzerland, Andorra, Liechtenstein, Monaco and San Marino) and the same measures in ten dependent or associated territories of the United Kingdom and the Netherlands (Guernsey, Jersey, Isle of Man, British Virgin Islands, Turks and Caicos Islands, Netherlands Antilles, Anguilla, Cayman Islands, Montserrat and Aruba). In October 2001 Ecofin mandated the Commission to open negotiations. These went on to the end of 2004.

---

22 See Presidency Conclusions of Helsinki European Council of 11 December 1999.

23 Note, however, that some members of this Group are also members of other groups described above.

24 See Annex IV to the Presidency Conclusions of the Santa Maria da Feira European Council of 19 and 20 June 2000.

25 See COM(2001)400 of 18 July 2001. On 13 December 2001 the Council approved a revised proposal for a Directive. On 5 March 2002 a standard format was adopted for the exchange of information.

In line with the conclusions of the Ecofin meetings of 26 and 27 November 2000, 21 January 2003 and 3 June 2003, the main thrust of the Directive is as follows:

- Its ultimate objective is the exchange of information. All Member States will one day automatically forward information on interest payments to residents of other Member States. All bar Belgium, Luxembourg and Austria introduce a system for automatically transferring information on the Directive's application. The three exceptions will introduce such a system after a transition period. During that period they levy withholding tax at a rate of 15% for the first three years, 20% for the next three years and 35% thereafter. They transfer 75% of the revenue from that withholding tax to the investor's Member State of residence.

- Belgium, Luxembourg and Austria will implement the automatic exchange of information (i) if and when the European Community reaches an agreement (by unanimous decision of the Council) with Switzerland, Liechtenstein, San Marino, Monaco and Andorra to exchange information concerning interest payments on request under the OECD's 2002 agreement on exchange of information on tax matters; (ii) if and when the Council agrees unanimously that the United States is committed to exchanging information on request under the same OECD agreement. The Directive also allows these countries to proceed to the automatic exchange of information before these conditions are met.

- The scope of the Directive is defined and includes interest payments on all sorts of debt claims, especially income from domestic or international bonds. The inclusion, at least in principle (see the next indent), of income from international bonds, including Eurobonds, marks a great step forward in that the UK opposed it for a long time. In addition to income distributed by CIUs, the Directive also applies to similar income going through structures used as substitutes for CIUs, and to income realised on the sale or redemption of parts or shares in coordinated CIUs with more than 40 % of their assets in debt claims. This threshold will, however, fall to 25% on 1 January 2011.

- "*A grandfather clause will be provided until the end of the transitional period: income from negotiable loan securities tied to issues for which the prospectuses have been certified by the competent authority before* [1 March 2001][26] *or, in the absence of any prospectus, to issues made before the same date, will not be covered by the Directive during that period*."[27] This clause is explained by the fact that contracts for the issue of negotiable loan securities can include a gross-up clause in which the issuer undertakes to provide investors with interest net of tax by bearing the cost of any change in tax law. However, the gross-up clause is usually accompanied by a redemption clause to protect the debtor from substantial changes in tax law. Without a grandfather clause, the financial markets could have been disturbed by a surge in the redemption of claims over a very short period as issuers took advantage of a fall in interest rates to repay loans contracted at higher rates.

[26] The initial date of 1 January 2001 was replaced by 1 March 2001 at the Ecofin meeting of 26 and 27 November 2000.

[27] See the press release for the Ecofin meeting of 26 and 27 November 2000.

- The mechanisms for identifying the paying agent and the beneficial owner of interest payments covered by the Directive were also defined and accepted. The paying agent is any economic operator (generally a financial institution) responsible for the payment of interest for the immediate benefit of the beneficial owner. Paying agents are therefore the final link in the chain of intermediaries. They are responsible for informing their tax administration of interest payments to individuals (beneficial owners) residing in other Member States or, in the case of Belgium, Luxembourg and Austria, for levying the withholding tax during the transition period. The Directive also lays down basic procedures for establishing the identity and place of residence of beneficial owners.

- The Directive was to be implemented in national law by 1 January 2004 (1 May 2004 for the ten new Member States). Its provisions apply from 1 July 2005[28]. Agreements with five non-member countries (Switzerland, Andorra, Liechtenstein, Monaco and San Marino) on equivalent measures, and with the relevant dependent or associated territories of Member States on the same measures as those of the Directive, apply from the same date.

The external negotiations on the Directive on savings income accounted for a lot of the work carried out in the matter. One major result was the adoption of common rules in an area far greater than the EU. At its meeting of 16 October 2001, Ecofin launched the negotiations with the non-member countries mentioned in the Santa Maria da Feira conclusions by authorising the European Commission to open formal negotiations. The Commission was mandated to conduct negotiations in close conjunction with the Council Presidency and in regular consultation with the High Level Group on the Tax Package. In follow-up to the negotiations, Ecofin accepted, on 21 January 2003, that practices in the United States were already equivalent measures and that the Community should conclude agreements with the other above mentioned five countries including a withholding tax, voluntary disclosure of information, a review clause and a provision on an exchange of information on request in cases of tax fraud and similar misbehaviour. At its meeting of 3 June 2003, the date of the adoption of the Directive on savings income, Ecofin approved the text of the agreement with Switzerland, including a provision requested by Switzerland which extended to Swiss firms some of the advantages of the Parent/Subsidiary Directive and the Directive on interest and royalty payments.[29] A year later, on 2 June 2004, Ecofin noted with satisfaction that agreement in principle had been reached on all matters of substance with the relevant dependent and associated territories of Member States and with Andorra, Liechtenstein, Monaco, San Marino and Switzerland on the necessary arrangements to enable the Directive on savings income to be applied. Because Switzerland was unable to apply the Directive from 1 January 2005, the Council accepted, at its meeting of 19 July 2004, the date of 1 July 2005.[30]

---

[28] The original application date was 1 January 2005. In accordance with Article 17(3) of the Directive, the Council, on a proposal from the Commission, adopted a Decision on 19 July 2004 postponing the date of application to 1 July 2005.

[29] Spain was granted a temporary derogation for the application of this provision in its bilateral relations with Switzerland.

[30] The agreement with Switzerland was signed on 26 October 2004. The agreement with Andorra was signed on 15 November 2004. The agreements with the other three non-member countries were signed on 7 December 2004.

1.3. Taxation of interest and royalty payments

Aims

At its meeting on 1 December 1997, Ecofin decreed, as the third component of the Tax Package, that "*the Commission should submit a proposal for a Directive on interest and royalty payments"* between Member State companies. This was done in March 1998.[31]

In practice, the Directive is aimed at exempting the lion's share of cross-border interest and royalty payments between associated companies from taxation at source. There are a number of good reasons for doing so. First, in a single market, transactions between companies of different Member States should not be subject to less favourable tax conditions than those applicable to the same transactions carried out between companies of the same Member State. This requirement was not fulfilled by a number of tax rules which existed before the Directive on interest and royalty payments was adopted. Second, national tax laws coupled, where applicable, with bilateral agreements did not ensure that double taxation was completely eliminated. Third, the application of the existing rules often entailed burdensome administrative formalities and cash-flow problems for the companies concerned.

A number of technical issues were discussed. With regard to the scope of the Directive, the main issue was whether the Directive would cover just the forms of company listed in the annex to the Merger and Parent/Subsidiary Directives or all companies subject to corporation tax. Another topic was the nature of the requisite relationship between associated companies: at issue was whether only direct holdings were to be taken into account or whether indirect holdings would also count. Greece, Portugal and, to a lesser extent, Spain stressed the financial impact the Directive would have on their tax take. As net importers of technology and capital, these countries benefit more than others from the taxation of cross-border interest and royalty payments. They therefore insisted on special treatment for a transition period. There was also discussion of whether royalties should include payments received in remuneration for the use or enjoyment of software and for leasing. Lastly, a number of Member States did not want the Directive to apply when interest and royalty payments are subject, by way of derogation, to preferential treatment in the beneficiary's Member State.

Method

The third component of the Tax Package, the proposal for a Directive on the taxation of interest and royalty payments is sometimes seen as the least important of the three in political and budgetary terms. For this reason it, unlike the other two components of the Tax Package, was the subject of very little negotiation in high-level groups.

---

[31] See Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (COM(1998) 67 final). This proposal follows up a proposal for a Council Directive presented by the Commission on 28 November 1990 but subsequently withdrawn [COM(1993) 196 final].

Most of the debate took place in a Council tax working group. The results were then approved by Ecofin, maintaining a very clear link between this dossier and the other two. Thus, though political agreement was reached on the main issues at the Ecofin meeting of 25 May 1999, it was stated that "*this Directive is part of the Tax Package adopted under the Luxembourg Presidency on 1 December 1997. Only in that context will final adoption take place.*"

Outcome

Those issues relating to the Directive on interest and royalty payments still to be resolved in 1999 were settled at the Ecofin meeting of 26 and 27 November 2000. The Council formally adopted the Directive on 3 June 2003 as part of the overall agreement on the Tax Package.[32]

Under that agreement, the list of company forms was that featuring in the Merger and Parent/Subsidiary Directives at that time[33]. Greece and Portugal were granted an eight-year transition period, during which they were authorised to apply a withholding tax of up to 10% for the first four years and up to 5% for the subsequent four years. Spain too was granted, though only for royalty payments, a transition period of six years from the beginning of the plan for boosting the country's technological potential. During the transition period Spain is authorised to apply a withholding tax of not more than 10%. Note that the definition of royalties includes software and leasing.

Since June 2003 other developments have taken place. Two new Directives have been adopted in connection with the accession to the EU of ten new Member States. Since the June 2003 Directive was adopted after the candidate countries signed the Act of Accession but before the Act's entry into force, the Directive had to be amended to apply to the new Member States from the day of accession. A Directive[34] was adopted to that end on 26 April 2004. Moreover, given the very tight deadline for implementing the new Directive before accession, it was to be expected that some candidate countries would experience difficulties. A new Directive was needed to grant five candidate countries transition periods in respect of the taxation of interest and/or royalty payments.[35]

As indicated above, the Agreement between the European Community and the Swiss Confederation providing for measures equivalent to those laid down in the Savings Directive provides, *inter alia*, for the elimination of withholding taxes on interest and royalty payments between a company in Switzerland and an affiliated company in an EU Member State. The Agreement began to apply on 1 July 2005.

---

32 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 (OJ No L 157, 26.6.2003).

33 In the meanwhile, the list annexed to the Merger and Parent/Subsidiary Directives has been extended to include, inter alia, the European Company and the European Cooperative Society.

34 Council Directive 2004/66/EC of 26 April 2004 (OJ No L 168, 1.5.2004).

35 Transition periods were granted to the Czech Republic (six years) and Slovakia (two years) for royalties. Latvia, Lithuania and Poland were granted six-year transition periods for interest and royalty payments. See Council Directive 2004/76/EC of 29 April 2004 amending Directive 2003/49/EC (OJ No L 168, 1.5.2004).

2. Current issues and policy options

The previous section presents the process which led to the adoption of the Tax Package. It recalls the main elements of each of its three elements components, i.e. the specific outcome of the long negotiation of the package.

This section focuses on the recent developments in these three policy areas. It offers an overview of some of the main policy issues under discussion. The three elements of the Package are examined in turn.

2.1. The Code of Conduct for Business Taxation

Recent developments

An important element underlying many discussions regarding the Code of Conduct relates to the impact of the Code on Member States' (and other countries') tax systems.

Most Member States have lowered the general corporate tax rates in an effort to enhance their attractiveness for the location of business activities (either domestic or foreign) or profits. It is sometimes argued that the elimination of harmful tax regimes as a result of the Code of Conduct work has been one significant factor in explaining this trend. This has led to extreme examples of some dependent and associated territories where the rollback of harmful tax measures has been accompanied by the introduction of a 0% rate or the complete abolition of corporate income tax.

Furthermore, tax publications seem to argue that EU Member States are more and more confronted with the transfer of mobile assets of companies to group companies outside the EU. One of the main motivations for the transfer of these assets seems to be found in the advantageous tax treatment of income on these assets in several non-EU jurisdictions, leading to a low effective level of taxation. It is recognised that these activities are highly mobile and, in absence of equivalent low effective tax rates in the EU, one might argue that the Code process has driven these assets and activities away from the EU. On the basis of the outline of the Code of Conduct and the intentions at the start of the process many Member States were looking, in first instance, to unfair tax competition which was being conducted within the EU borders, and in some cases their associated and dependent territories. There was also the intention to broaden the fight against harmful tax competition to countries outside the EU, which was partly achieved by the OECD process against harmful tax practices.

Apart from these efforts, another result of the Code process could have been the practice of copying the lowest benchmark. The Code of Conduct Group has approved regimes, after amending proposals, which still include features that are advantageous or open opportunities for tax planning schemes. The fact that the Group has allowed such features to continue in some tax regimes has led to the creation of "benchmarks". In practice it means that Member States having to make changes to their existing measures because these are declared harmful, or Member States designing a new measure, can design a tax regime based on the "lowest" level accepted by the Code Group for the different features of the measure. Examples of such practices may include liquidation loss provision regimes, holding company regimes, shipping regimes and collective investment funds regimes.

Policy issues

On the basis of developments to tax systems within EU Member States one could consider the need for widening the scope of the measures covered by the work of the Code. For example, already during the discussions concerning the drafting of the Code of Conduct, some Member States pleaded for a wider scope than finally agreed. This is also reflected in the preamble of the Code where the Council recalled that certain Member States, and the Commission, considered that special tax arrangements for employees ("expatriate regimes") could come within the range of the issues covered by the Code.

A similar point of discussion concerning the coverage of the Code can be found in preferential regimes, which include features at the (corporate) shareholder level, by refunding corporation taxes of the distributing company. It has been argued by some that these regimes are not covered by the Code. So far, the majority of Member States nevertheless considered that these measures are covered by the Code. However, it cannot be excluded that there will be further attempts to design tax measures that are harmful within the spirit of the Code while being arguably outside the literal scope of the Code. This could significantly weaken the effectiveness of the Code of Conduct.

Apart from these measures there may be others which, either because they were not covered by the scope of the Code or because they were not identified as problematic at the time, were not subject to an evaluation by the Group but in fact may constitute harmful tax measures. One such area is the use of different forms of hybrid entities or hybrid capital[36] and the effect that can be achieved by taking advantage of the differences in treatment that exists in different tax systems. The use of qualification differences between Member States is widespread in current tax practice. It could be useful to describe the practices used to review the rulings given by tax authorities in this field and to discuss with Member States possible strategies to combat these forms of tax avoidance.

Overall, these issues highlight that some review of the Code of Conduct could be useful in the future, in order to ensure that the criteria used in the Code are adequate in determining whether a measure is harmful or not.

However, it is sometimes argued that a revision of the Code would not solve an important problem, namely the lack of a level playing field between those countries and territories which have implemented the Code and those that have not. The Member States and their associate and dependent territories have undertaken an important work to eliminate their harmful tax regimes. This has led, to a certain extent, to the relocation of related activities or profits to countries which have not undertaken comparable efforts to eliminate their harmful regimes. Therefore, as a complement to the above, a reflection on the ways to maintain a level playing field would also seem necessary.

Two options can in particular be envisaged in order to achieve a level playing field. The first option consists in promoting the adoption of the principles of the Code of

[36] Hybrid entities, i.e. entities which are considered as a corporate body (opaque) by one Member State and as non-corporate (transparent) by another Member State. hybrid capital, i.e. the difference of qualification by Member States of debt / equity.

Conduct on as broad a geographical basis as possible, as foreseen in paragraph M of the Code. In practice, explicit reference to the Code of Conduct has been included in action plans related to countries participating in the European Neighbourhood Policy. It is envisaged that due reference to the Code is inserted in future relevant economic partnership agreements. Moreover, the Commission indicated that it is willing to support international (OECD) and EU tax standards in the 10th European Development Fund. In this respect, the OECD Global Forum made significant efforts in identifying a possible level playing field in the area of transparency and exchange of information for tax purposes, and conducted a comprehensive review of over 80 tax systems[37]. This work may contribute to removing harmful tax competition from third countries.

A second option could also be envisaged, where Member States would be allowed to offer specific tax advantages for certain types of income. This solution could be focussed on specific types of income and should avoid the erosion of EU tax bases. The most important goal for the EU would be to prevent these highly mobile assets leaving the EU. In the discussions prior to the November 1999 report it was mentioned that fierce global competition could be used as an argument to give special treatment for certain types of activities. Along these lines one could argue that the EU could allow a specific type of income to be taxed at a separate rate (a lower rate than the general applicable EU average rate, for example 10%).

2.2. *The Savings Directive*

<u>Recent developments</u>

On 1 July 2005, the provisions of the Council Directive 2003/48/EC on taxation of savings income in the form of interest payments (the "Savings Directive") started to be applied by all the (then) 25 Member States on the basis of most of the principles agreed in 1997 (see section 1.2), apart from the one related to the permanent character of the coexistence model. The same measures in the Directive are also applied since the 1st of July 2005 in 10 dependent or associated territories through the implementation of bilateral agreements signed by each of the Member States with these jurisdictions; and equivalent measures are applied in 5 European third countries, including Switzerland, and the USA. On 1 January 2007, the number of participating jurisdictions was raised to 42 following the accession of Bulgaria and Rumania to the EU.

A summary of available figures (as at 8 September 2006) on the amounts of withholding tax levied between 1 July and 31 December 2005 under the Directive on taxation of savings (Council Directive 2003/48/EC) and the related agreements[38] is provided below.

---

37 See OECD (2006), "Tax co-operation: towards a level-playing field", Paris.

38 It is important to note that, following the Conclusions adopted by the ECOFIN Council on 12 April 2005, only interest income accrued after 1 July 2005 is subject to withholding tax at the moment of payment. It is also important to note that some of the UK territories which agreed to apply the savings taxation measures in the form of a withholding tax (namely Isle of Man and Turks and Caicos Islands) have a fiscal year which does not end on 31 December: the revenue of the withholding tax levied by these territories from 1 July 2005 is therefore known and partially transferred to the EU Member States at a later moment than for the other withholding tax countries and territories.

Country applying the savings taxation measures in the form of a withholding tax	Total amount levied – in millions of the national currency	Total amount in millions €	Detail of distribution by MS of 75% of this amount	Comment
Austria	€13	€13	Detailed on the Austrian Federal web	
Belgium	€10	€10	Available only for LU	Oral questions 11221 and 12282 / 2006 (BE parliament)
Luxembourg	€48	€48	Not available	Interview released on 17 May 2006 to "Luxemburger Wort" by Budget minister Frieden
Jersey	£13	€18,74	Not public	Press release on 12 June
Guernsey	£4,5	€6,49	Not available	Press release on 15 June
Isle of Man	N/A			Tax year ends on 5 April
Turks and Caicos Islands	N/A			Tax year ends on 30 September
Liechtenstein	CHF 4	€2,55	Not available	Press release on 6 April
Switzerland	CHF 159,4	€101,68	Yes, in the press release	The Press release on 29 June provides also details on the exchange of information under the voluntary disclosure procedure

These figures allow for a preliminary analysis of savings income earned in the form of interest by EU non residents in these jurisdictions. To take one example, with some €2,5 million (CHF 4 million) savings tax collected in Liechtenstein in the second half of 2005 at 15% tax rate, the total interest subject to the "tax retention" provided for by the agreement with the EU was approximately €16,9 million. Based on an estimated average interest rate of 3%, and considering the fact that only interest income accrued and paid in the second semester 2005 can be subject to the tax, the total savings capital concerned for 6 months would have been €1,2 billion. Similar estimates can be done for the other countries or territories, *mutatis mutandis*.

<u>Policy issues</u>

The Directive provides in Article 18 for a review after three years of experience gained in applying the Directive, on the basis of a Commission report. If appropriate, amendments to the Directive will be proposed to the Council to ensure effective taxation of savings income and to remove undesirable distortion of competition. Several elements of the savings directive, which could be considered for review, are examined below:

– Transposition and interpretation of the Directive as it stands and questions of conformity with its aim

The detailed transposition of the Directive into the 27 national legislative and administrative systems is quite recent and the first exchanges of information and transfers of withholding tax revenues, concerning interest payments made in the second semester of 2005, occurred around mid-2006. It is therefore premature to make an in-depth assessment of the quality and the actual effectiveness of the Directive at this stage. Such an assessment will only be possible after significant experience of its implementation.

However, some preliminary issues related to the transposition or interpretation of the Directive can already be raised. A first possible problem may be the treatment of non-UCITS[39] investment funds and funds of funds, the treatment of vehicles like trusts and the treatment of certain derivative products that, rather than being really innovative financial products, could be concretely used as an alternative to investment in debt-claims. There could be a need for comparing the different approaches regarding the treatment of all these financial instruments in order to ensure that the application of the relevant sections of the current text of the Directive reflect correctly the true intentions of the Council and to avoid undesirable distortions within financial markets.

– Geographical scope of the savings tax measures

At the ECOFIN Council of 21 January 2003, the Council asked the Commission to continue discussing possible improvements to information exchange with the US, Switzerland, Liechtenstein, Monaco, Andorra and San Marino, as well as to start, after 1 July 2005, new discussions with additional important financial centres with a view to promoting the adoption of measures equivalent to the Directive also in those locations.

On 23 October 2006, the Council invited the Commission to start exploratory talks to this purpose with Hong Kong, Singapore and Macao, in order to achieve a level playing field in the financial service sector with these jurisdictions.

– Content of the Directive

Beyond an assessment focusing on the geographical scope, the transposition or the interpretation of the directive, it is useful to examine possible ways to render the Directive more effective without hindering companies' activities. This could lead to proposals for more substantial modifications to the Directive.

As highlighted by the preamble to the Directive, its aim is to enable savings income in the form of interest payments, made in one Member State to beneficial owners who are individuals resident in another Member State, to be made subject to effective taxation in the country of residence of such individuals. Therefore, only interest payments to individuals, or interest income obtained by individuals through the intermediation of certain types of investment funds, fall within the scope of the Directive. All payments to legal persons are, for the time being, excluded. Other forms of income from financial investments, like dividends and payments from pension funds or unit-linked life insurances, are also excluded

[39] UCITS= Undertakings for Collective Investment in Transferable Securities.

from its application. This is also the case with proceeds from innovative financial products, which have been excluded from the present scope of the Savings Directive, but left subject to the review of the Directive provided for under Article 18, by the conclusions of the ECOFIN Council of 25 May 1999.

In the future, certain types of savings income, which had initially been excluded from the scope of the Directive, could be added to that scope. This could, for instance, be the case with income from unit-linked life insurances or pension schemes, and possibly also with dividends paid to individuals. The inclusion of such elements of income within the scope could possibly also benefit individuals, if a complete elimination of double taxation on that income could be obtained through the application of the Directive. One could also examine how to extend the scope of the Directive to include payments of capital income made to those legal entities acting as intermediaries between the source of savings income and the individuals, when this intermediation prevents the effective application of the Directive to the ultimate beneficiary. This problem does not only arise with legal entities established in Member States but also with those established in off-shore centres.

It is sometimes argued that a different approach to the one underlying the Savings Directive should be envisaged in the future. The Directive is based on the notion that, within an internal market where capital can move freely, the state of residence of the individual investor should be able to tax the cross-border savings income of its resident taxpayers in accordance with its own national tax laws, thus not requiring Member States to harmonise their tax treatment on such income. This approach is consistent with current international tax principles which attribute the taxing rights on passive income primarily or exclusively to the state of residence of the investor, and which -at most- grant a limited taxing right to the state of source (see e.g. Articles 10-12 of the OECD Model Tax Convention). This approach is premised on the assumption that the state of residence has sufficient knowledge of such cross-border payments. In practice, this requires a considerable degree of administrative co-operation and exchange of information which some countries may currently not be willing or able to provide due to national provisions or practices which limit access to bank information for tax purposes[40]. The current policy objective, both within the EU and the OECD, is to try and remove such obstacles and to promote effective exchange of information. An alternative would be to move away from residence based taxation towards source based taxation by ensuring that savings income is subject to an equivalent level of taxation in the countries where such income arises. Such an approach would most likely involve the introduction of harmonised source-type withholding taxes on different types of savings income, possibly combined with anti-abuse measures to deal with those countries or territories which are not willing to levy such taxes. Under this approach, passive foreign source income would no longer be subject to progressive income taxation in the state of residence of the investor and there would thus be less need for exchange of information on such payments.

[40] See the OECD report *Improving access to bank information for tax purposes* (2000), and the 2003 Progress report

2.3. *Taxation of interest and royalty payments*

Recent developments

In September 2005, the Commission requested the International Bureau of Fiscal Documentation (IBFD) to carry out a survey of the implementation of the Directive (including the amending Directives) and the (EC-Swiss Savings) Agreement[41]. This report highlighted that, while the implementation has generally taken place in a timely manner, there appears to be some risk that certain key concepts of the Directive will be interpreted differently in different Member States. In some cases this could lead to relief being denied in one Member State whereas it would be available, in otherwise identical circumstances, in another Member State. Therefore, further discussions and clarification of concepts such as interest, royalties, beneficial ownership, etc. may be necessary in the future.

Policy issues

On 30 December 2003 the Commission adopted a proposal for a Council Directive amending the Directive of June 2003 on interest and royalty payments. There were two strands to the proposal.

First, the Commission proposed amending Article 1 of the Directive so that Member States have to grant the benefits of the Directive only where the interest or royalty payment concerned is not exempt from corporate taxation. It followed up the statement in the conclusions of the Ecofin meeting of 3 June 2003 that "*the Council and the Commission agree that the benefits of the Interest and Royalty Directive should not accrue to companies that are exempt from tax on income covered by that Directive. The Council invites the Commission to propose any necessary amendments to this Directive in due time.*"

It also proposed amending the list of entities covered by the Directive to include other forms of company, and in particular the European company. In short, the aim was to bring this Directive's list of eligible companies into line with that of the Parent/Subsidiary Directive" (as amended on 22 December 2003). The discussions on the proposal for a Council Directive amending Directive 2003/49 are still under way[42]. In absence of agreement, there is some doubt as to whether Member States can deny the benefits of the Directive to companies that are subject to no, or only a very low, tax on interest and royalty payments. Besides, the European Company and the European Cooperative Society are not explicitly covered by the Directive. Lastly, the Directive applies to fewer types of companies than the Parent-Subsidiary Directive.

Besides, the above-mentioned IBFD survey suggests that some work could be necessary in order to clarify concepts used in the Directive and coordinate the Member States' positions in this respect.

---

41 IBFD (2005, "Survey on the Implementation of the EC Interest and Royalty Directive". Available on http://ec.europa.eu/taxation_customs/common/publications/studies/index_en.htm

42 Article 8 of the Directive (2003/49) foresees that, by 31 December 2006, the Commission shall report to the Council on the operation of the Directive, "in particular with a view to extending its coverage".

3. A flashback to the Verona Strategy

This section examines a number of particularly interesting aspects of the Verona Strategy and draws more general conclusions about the EU's decision-making processes in tax matters.

3.1. A comprehensive approach

In a decision-making process based on unanimity, as is the case with tax matters at EU level, a Member State has to get something out of the negotiations. Otherwise it has every incentive to veto the proposals made. In other words, it is not enough for a proposal to benefit the EU as a whole; it has to benefit each Member State individually. This has major implications for EU tax policy: any proposal that fails to satisfy this condition is doomed to failure, no matter how great the potential benefits of its implementation to the EU as a whole.

The "comprehensive" approach developed at Verona and the creation of a Tax Package were particularly useful in that they acknowledged this fundamental problem in European tax policy and addressed it by bundling a number of tax issues which, though not benefiting each and every Member State on their own, did benefit the EU as a whole. In this way, each Member State drew a net advantage from the body of components making up the Tax Package.

Though there is nothing new about linking a number of issues (especially not at EU level), explicitly linking, from the very outset, a number of issues which were not necessarily clearly related was, however, a highly innovative step in the tax sphere. It is interesting to note that the Directive on interest and royalty payments, on which agreement had been reached in 2000, remained on hold until the other two components of the Tax Package were wrapped up.

The success of the Tax Package contrasted with the failure to adopt any other directive on direct taxation since 1990. This might be taken as meaning that the only way to achieve further substantial progress on tax matters at EU level is by means of a comprehensive approach or the creation of tax packages.

This is, however, far from certain, since a comprehensive approach poses a variety of problems. Side-by-side negotiations on a number of issues demand that both the Member States and the Commission dispose of appropriate political will – and the necessary human resources. The issues must also be chosen carefully: there must be the prospect of substantial benefits. In the light of past experience, it is not certain that all Member States would back the creation of a new tax package.

3.2. A flexible negotiating structure

Though bundling issues may, in theory, facilitate negotiations and achieve a better outcome for all parties, it is, in practice, difficult to assess each party's gains and losses across a complex range of issues. It is therefore vital to develop a flexible, appropriate negotiating process that will keep score of such gains and losses.

From that perspective, it can be helpful to set up high-level working parties with variable mandates and working methods, drawn from experts in close contact with the Member State's governments, as the progress made by these working parties during the Tax Package bears out.

Similarly, the partial agreements reached at Ecofin meetings and European Councils also bring gradual progress towards an improved situation for the EU as a whole. Whenever a Member State reaches a potential sticking point in one area, it can be offered compensation in that or another area, within the predefined scope of the package. For instance, at Ecofin's meeting on 26 and 27 November 2000, Belgium obtained transition arrangements on savings (withholding tax) in exchange for progress on the Code of Conduct, a particularly sensitive matter in that country.

This flexibility in the framework and timing of negotiations offers quite a few advantages. But it also has serious disadvantages akin to those associated with a comprehensive approach: cumbersome negotiations, lack of transparency, multiplicity of negotiating bodies, coordination difficulties for the Council, Commission and Member States, and the absence of an overview at the level of the technical working parties, which leave Ecofin to sort out the political trade-offs between dossiers. These disadvantages suggest that a standing high-level working group (or committee) specialising in tax issues might render the same services as the various high-level working groups and facilitate the preparation of Council negotiations on tax while operating in a clearer, more effective legal framework than currently exists. The Taxation Policy Group's role in preparing negotiations should not be underestimated either.

3.3. An open geographical framework

In an economic environment characterised by great mobility of goods, services and capital, it is not always optimal to confine the debate to the EU alone. In particular, harmful tax competition often has repercussions far beyond the boundaries of the EU, as the current OECD discussions on the issue attest. It is therefore necessary to consider the geographical scope of mooted tax measures.

In the case of the Tax Package, some Member States stressed the need to keep advances inside and outside the EU (non-member countries, dependent and associated territories) in phase from the very outset of the negotiations.[43] An overall agreement on the Tax Package that did not respect this need for symmetry would undoubtedly have meant a loss for these Member States, even if it benefited the EU as a whole.

An interesting issue that emerged at the very outset of negotiations was how – on what terms – non-member countries or dependent and associated territories of Member States could be induced to adopt rules they would not have embraced of their own volition. To that extent the problem was the same as that of the Member States, save that the countries and territories concerned might feel they had everything to gain from not going along with the EU initiative: in a world where tax bases are increasingly mobile, free-riders stand to gain more and more from an uncooperative

---

[43] See, in particular, the Code of Conduct and the conclusions of the Santa Maria da Feira European Council.

policy at international level. Moreover, the non-member countries and dependent and associated territories concerned by the Tax Package are also in competition with other territories, and their participation in tax cooperation with the EU could give their competitors an undue edge.

The timing and strategy of the negotiations on the savings tax agreements with the five European non-EU countries were largely influenced by a specific element of the Council conclusions adopted in Feira on 20 June 2000. As a matter of fact, the adopted report of the ECOFIN Council to the European Council made the entry into application into the Community of the Savings Tax Directive almost *conditional* on obtaining a parallel application on interest paid to EU residents of the same or equivalent measures by the five European non-EU countries. It is sometimes argued that such condition made the negotiating position of the Community particularly difficult, as the non-EU countries concerned had been provided with the *de facto* power of vetoing the application inside the Community of an internal long-awaited legislative instrument. This probably gave some leverage in the negotiation to countries such as Switzerland[44].

Nevertheless, the negotiations were able to proceed pragmatically thanks to a degree of flexibility in the demands made on non-member countries and dependent or associated territories, e.g. application of a withholding tax rather than the automatic exchange of information. Furthermore, a number of incentives were offered in other matters. Switzerland, for instance, now enjoys the benefits afforded by the Parent/Subsidiary Directive and the Directive on interest and royalty payments. It is also possible that the negotiations on savings affected other discussions between the EU, or its Member States, and the countries and territories in question.

Looking back at the approach used with the key third countries, one would perhaps advocate that the Community should avoid to making an internal agreement explicitly conditional to the agreement of a third party. In this respect, it should be noted that no such similar obligation has been claimed by the Council or by the 5 European non-EU countries for the future discussions to be held with other financial centres on taxation of savings.

It is also significant that the EU's negotiations with these countries and territories did not involve "defensive" measures. This could be explained by the inherent difficulty of taking a hard line when any decision has to be unanimous. Such measures could, however, be envisaged in the future, especially if they target market operators rather than states *per se*. The conditions laid down by the United States in respect of its "qualified intermediaries" could well inspire future international tax discussions.

---

[44] See the views expressed on the Swiss federal official website on: http://www.europa.admin.ch/nbv/uebersicht/f/index.htm.

Conclusions

Recent history shows clearly that the EU's Member States are not ready to give up their sovereignty in tax matters and accept harmonisation in such crucial area as income tax. It is also clear, however, that the process of European integration does make tax bases more mobile, effectively reducing the Member States' autonomy in tax policy setting. This trend is amplified by the increasing impact of the case-law of the Court of Justice of the European Communities. Tax competition between Member States and their partners in the EU, dependent and associated territories and with third countries is causing loss of tax revenue and distorting the very structure of taxation. This can have serious consequences, for instance on employment. Ironically, a policy of cooperation at EU and international level now seems to be one of the only ways for governments to recover the room for manoeuvre they sometimes lack in tax matters.

These considerations led the EU to develop an ambitious project in the sphere of direct taxation, the Tax Package. A lengthy debate culminated in an overall agreement in June 2003. This outcome was basically attributable to an innovative tax strategy, which involved bundling a number of sensitive issues so that every Member State could be an overall winner. The use of high-level working parties made it possible to keep political and technical advances in phase and to keep track of each Member State's gains and losses. Lastly, the pressure brought by each Member State to bear on its partners made it increasingly difficult to rewind or halt the process as negotiations progressed. On the down side, however, the strategy demanded considerable resources for the negotiations, which would make its application in less important tax matters in the future more problematic.

The negotiations on the Tax Package highlighted the global dimension of tax issues. It could never have been concluded without the agreement of certain key third countries and dependent or associated territories of Member States. The tax debate thereby led to discussions on other aspects of the EU's relations with the countries or territories concerned. Were action against harmful practices to be stepped up in the future, the EU's Member States and institutions might consider explicitly linking the abolition of harmful tax practices to other issues, for instance trade or development aid, in order to encourage the adoption of international tax standards as widely as possible. Similarly, the activities of various international organisations with regard to harmful tax competition or related areas (e.g. money laundering or tax fraud) reinforce each other by putting the spotlight on the harmful practices of a few states at international level and by linking these different issues.

Looking beyond the Tax Package, the EU will have to make a number of strategic choices in tax matters. The Community's field of intervention in matters of harmful tax competition could be expanded to encompass additional forms of competition to those covered by the Tax Package. Special tax arrangements for expatriates are, for example, sometimes seen as a problem. Limits on statutory rates of business taxation could also figure on the agenda, provided a clear case is made to justify such a move.

Decision-making processes and "institutions" are also an important issue. First, the headway made at Nice and the last intergovernmental conference on enhanced cooperation hold out the prospect of major advances in areas where there is no unanimity in the Council. Second, the development of machinery for voluntary intergovernmental transfers facilitating the implementation of unanimous agreements could be useful – at least in theory — in certain specific cases. Lastly, the optimal structure for tax negotiations should be considered. The nub of the issue is whether to foster the existence of a loose negotiating structure based on a body of high-level working groups or to try and integrate these working groups into a more stable and coherent framework such as a Tax Policy Committee.

The Tax Package has brought major advances in matters of tax policy at EU level. Besides stimulating thought and discussion on tax competition, it has raised awareness among the Member States of the interdependence of their tax policies and of the potential benefits of cooperation at EU level.

TAXATION PAPERS

Taxation Papers can be accessed and downloaded free of charge at the following address: http://ec.europa.eu/taxation_customs/taxation/gen_info/economic_analysis/tax_papers/index_en.htm

The following papers have been issued.

Taxation Paper No 10 (2007): A history of the 'Tax Package': The principles and issues underlying the Community approach. Written by Philippe Cattoir.

Taxation Paper No 9 (2006): The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options. Written by Ana Agúndez-García.

Taxation Paper No 8 (2005): Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada. Written by Joann Martens Weiner.

Taxation Paper No 7 (2005): Measuring the effective levels of company taxation in the new member States : A quantitative analysis. Written by Martin Finkenzeller and Christoph Spengel

Taxation Paper No 6 (2005): Corporate income tax and the taxation of income from capital. Some evidence from the past reforms and the present debate on corporate income taxation in Belgium.Written by Christian Valenduc.

Taxation Paper No 5 (2005): An implicit tax rate for non-financial corporations: Definition and comparison with other tax indicators. Written by Claudius Schmidt-Faber.

Taxation Paper No 4 (2005): Examination of the macroeconomic implicit tax rate on labour derived by the European Commission. Written by Peter Heijmans and Paolo Acciari.

Taxation Paper No 3 (2005): European Commission Staff Working Paper.

Taxation Paper No 2 (2004): VAT indicators. Written by Alexandre Mathis.

Taxation Paper No 1 (2004): Tax-based EU own resources: an assessment. Written by Philippe Cattoir.