The creation of a European capital market is one of the major objectives of the internal market program. However, a certain provision of double taxation agreements and their application by a majority of the member states currently still limit the achievement of this objective.

This problem created by double taxation agreements and their application in the European Union consists of how source taxes charged to cross-border dividends and interest are effectively reduced. I am primarily concerned with so called portfolio-dividends. These are dividends which are received by individuals or by corporations which do not own a minimum of 10% of the shares of the foreign company, which usually gives them a more favourable treatment.

The tax treaty usually provides for dividends which are received by individuals with residence in another member state that the source tax is reduced to the treaty rate of 15%. In the classical case this is not so simple; first the full withholding tax of, for example, a rate of 25% is deducted and then the shareholder must file a special application for a refund of the excess source tax of 10%. This conforms to the classical Roman law principle of “solve et repete”. For that purpose the shareholder must first obtain the necessary form from the foreign tax administration, he must fill it out and get it stamped first by his bank and then by his tax office where he is registered as a resident. Then he can file the form either directly with the competent tax office of the foreign state or give it to his own bank which will pass the application on to the foreign tax office. Special problems can arise, when the shares are owned by a number of persons (which can even happen in case of spouses) or the investor has deposited shares with different banks in different countries. Similar problems come up when foreign dividends are received via a domestic or foreign investment fund. But I do not want to elaborate on those complications, but rather remain with the simple case that the Investor deposited
his shares in a bank in his country. The investor is willing to explicitly give up vis-à-vis the foreign and his own tax authorities any benefit from a bank secrecy which may exist.

The classical refund procedure for foreign source tax is both time consuming and costly because

− banks charge more and more for each confirmation, etc. (at least 10 Euro per dividend flow),
− many investors let the bank or the tax advisor get the form and have them fill it out,
− the investor has his own additional costs (for example for keeping track of his receivables),
− the investor also loses interest by not filing the application for each country immediately after the dividends are received but - this also depends on the amount of the individual dividend payment - maybe only once a year, and also the application takes some time; in addition some member states have a reputation of taking years to make the refund;
− finally when the refund amount is paid by the foreign fiscal authority, again banking fees for transfers from abroad and exchange costs occur, particularly when the source state and the resident state do not belong to the Euro-group.

Is it surprising when many small shareholders owning foreign stock refrain from requesting the refund of the source state because in the end “the gravy is getting more expensive than the beef”? In this instance when no application is filed for the refundable part of the source tax, then in the shareholder’s country of residence this part of the tax can usually neither be credited against personal income tax nor be deducted as a deductible expense. It is understandable that small investors refrain from buying any foreign stock. Thus they give up the advantage of border-crossing diversification which is the essence of investing in an internal market.

The amount in source taxes of which for the reasons given the refund is not claimed, is estimated for Germany to amount up to 300 to 400 million Euro per year. For the whole European Union this estimate may easily increased to more than a billion Euro. This situation is not acceptable within the European Union because it contradicts the objective of a common capital market.

Of course it should be mentioned that there are investors who do not claim the refund of source tax because they do not want to declare dividend or interest income in their country of residence. At times they have secret accounts in third countries but also in
try of residence. At times they have secret accounts in third countries but also in certain member states. In my opinion, this group is not included in the above estimate.

**What can be done?**

In the first place I would like to mention that a number of important third countries like the United States, Canada and Japan trust the declaration of residence of the tax payer which is confirmed by the bank where the shares are deposited and to which the dividend payments flow. For example, a German resident holding shares in a US corporation from the beginning is only charged the reduced source tax rate of 15 % instead of being charged the full US-tax rate of 30 % when he receives dividends in his German bank account.

More recently, similar agreements have been made between individual banks and some foreign tax administrations, such as Norway, Sweden, Czech Republic, Canada, Australia, New Zealand and Finland. More agreements are in preparation.

Why should this system not be possible within the European Union in general? As early as 1992 two members of the European Parliament asked the Commission this question but received a rather negative answer.¹ The cross-border takeover of a German major bank by a European bank makes this issue even more acute, particularly since the home state of the acquiring bank has a reputation of not being a fast payer of refund claims. In the comparable case of the takeover of the German Hoechst AG by the French SANOFI S.A. several years ago, the French tax authorities have created special rules particularly for small shareholders.

In my view, the member states should do something about this issue based on their obligations under the Treaty of Rome. If this doesn't happen, then the Commission should step in, in my view preferably jointly the directorates general Taxud and Internal Market.² Particularly when the common capital market is to be extended to the area of small and medium sized private investors, this issue must be taken care of. Another justification can also be seen in the registration of tax payers in the framework of the savings directive. The next step would be the corresponding application to investment funds.

¹ Written Questions No. 647/92 by the Members of Parliament Randzio-Plath and Peijs.
² Since April 2005 this question and similar issues are studied by the Fiscal Compliance Experts’ Group - FISCO, organized by DG International Market and Services. The group, chaired by the Commission, will advise on the removal of fiscal compliance barriers to the clearing and settlement securities transaction within the EU. It is composed of 15 high-level experts, mainly from private bodies. Its final proposals are expected for 2007 (IP/05/434).