Company taxation: Commission proposes amendments to Interest & Royalties Directive

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The European Commission has made a proposal to broaden the scope of the European Community's Directive that provides for the elimination of withholding tax in the case of payments of interest and royalties between associated companies of different EU Member States (2003/49/EEC). The changes would see the Directive cover a larger range of companies including the European Company (see IP/01/1376) and the European Co-operative Society (see IP/03/1071). The proposal would also, at the request of the EU's Council of Ministers, eliminate a loophole by providing that the Directive would not apply to companies that are exempt from tax on interest and royalties received. The proposal is in line with the Commission's strategy for the EU's future tax policy presented in 2001 (see IP/01/737) in which the Commission stated its view that double taxation due simply to the cross-border nature of economic activity cannot be accepted, but that its elimination should not create opportunities for tax avoidance and evasion and neither should any greater co-ordination of Member States' tax systems give rise to unintentional non-taxation.

"This proposal would be another important step towards removing all forms of double taxation and other tax obstacles currently encountered by companies exercising their freedom to operate across borders within the Internal Market," commented Taxation Commissioner Frits Bolkestein. "At the same time, the proposal would make a necessary change to the Directive to ensure that it does not give rise to tax avoidance."

The proposal

The main elements of the Commission's proposal to improve the operation of the "Interest and Royalties" Directive are as follows:

First, it would update the list of companies to which the Directive applies to cover new, specified, legal entities, including certain co-operatives and non-capital based companies, mutual companies, savings banks, funds and associations with commercial activity. The new list would include the European Company and the European Co-operative Society that can be created from 2004 and 2006, respectively, with the result that companies and co-operatives operating in more than one Member State will have the option of establishing themselves as single entities under Community law. This proposed extension in scope corresponds to changes which the Council recently agreed to the Directive dealing with the taxation of dividends paid by subsidiary companies to their parents and changes that the Commission has proposed to the Mergers Directive (see IP/03/1418).

Second, the proposal would make it clear that Member States have to grant the benefits of the Interest and Royalties Directive only where the interest or royalty payment concerned is not exempt from corporate taxation in the hands of the beneficial owner. In particular, this addresses the situation of a company paying corporate tax but benefiting from a special national tax scheme exempting foreign interest or royalty payments received. In such a case the source state would not be obliged to exempt the payments from withholding tax. It was the Council of Ministers that requested the exclusion of exempt companies from the scope of the Directive at the time of the Directive's adoption in June 2003 (see IP/03/787).
The Commission proposes that Member States would bring these changes into force by 31 December 2004.

Background

Directive 2003/49/EEC that entered into force on 1 January 2004 is designed to eliminate taxes levied at source on payments of interest and royalties between associated companies of different Member States. Taxes levied at source, either by deduction (i.e. withholding taxes) or by assessment, in Member States on interest and royalties paid to companies resident in other Member States can create problems for companies engaged in cross-border business. In particular, such taxes can involve time-consuming formalities, result in cash flow losses and sometimes lead to double taxation. Associated companies must have cross-shareholdings of at least 25%.

The Directive is designed to relieve double taxation but not to facilitate non-taxation. The Directive therefore includes provisions to ensure that Member States are not precluded from taking steps to combat fraud or abuse. Such steps could include denying companies the benefits of the Directive. It is for this reason also that the Council requested the Commission to make the present proposal to exclude from the benefit of the Directive companies that do not in fact suffer any corporation tax on interest or royalty payments received.

Transitional arrangements have been provided for Greece and Portugal for both interest and royalties and for Spain for royalties in order to alleviate the immediate budgetary impact of the Directive on those countries. Under these arrangements, Greece and Portugal will not apply the Directive until the EC Savings Directive, 2003/48/EC, takes effect on 1 January 2005 and Spain will not apply the Directive to royalty payments until that same date. Subsequently, Greece and Portugal will be allowed to apply a withholding tax on payments of interest or royalties that must not exceed 10% during the first four years and 5% during the final four years. Spain will, during a transitional period of six years starting on the same date of 1 January 2005, be authorised to apply a rate of tax on payments of royalties that must not exceed 10%.