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COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION TO THE COUNCIL

**in accordance with Article 8 of Council Directive 2003/49/EC on a common system of
taxation applicable to interest and royalty payments made between associated
companies of different Member States**

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1. SUMMARY

Article 8 of Council Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States ('the Interest and Royalties Directive' or 'the Directive')¹ requires the Commission to "...report to the Council on the operation of this Directive, in particular with a view to extending its coverage to companies or undertakings other than those referred to in Article 3 and the Annex." In response, the Commission has looked at timeliness and completeness of implementation, as well as at issues of interpretation and possible improvements to the existing text, including broadening the scope of the Directive. The report concludes that while the Directive has generally been implemented in a timely and complete manner, there is a need for guidance and coordination in respect of certain key concepts, as well as scope for improving the current text.

2. BACKGROUND

The Directive was adopted on 3 June 2003. The deadline for implementation was 1 January 2004. It has subsequently been amended by Council Directives 2004/66/EC² and 2004/76/EC³. The former extends the application of the Directive to companies and taxes of the new Member States (MS), while the latter grants some of the new MS temporary derogations from one or more provisions of the Directive. Both amending directives were to have been implemented by 1 May 2004.

In view of the Article 8 report, the Commission asked the International Bureau of Fiscal Documentation (IBFD) to carry out a survey of the implementation of these Directives. The information to be provided by the survey was intended to allow the Commission to assess the need for:

- action to ensure compliance with MS' obligations under the Directive and under the Treaty;
- guidance on the application of the individual provisions of the Directive;
- further legislation within the area covered by the Directive.

It was agreed that the survey should cover only 20 MS, thus excluding five MS (Greece, Latvia, Lithuania, Poland and Portugal) benefiting from transitional derogations, since no obligations exist yet for these MS to implement fully the Directive. While the survey was completed before the accession of Bulgaria and

¹ OJ L157, 26.6.2003, p. 49.

² OJ L 168, 1.5.2004, p. 35.

³ OJ L 157, 30.4.2004, p. 106.

Romania to the European Union, it should be noted that those MS also benefit from transitional derogations⁴.

3. THE DIRECTIVE

3.1. Purpose and scheme

The purpose of the Directive is to put cross-border interest and royalty payments on an equal footing with domestic payments, by eliminating juridical double taxation and cash-flow disadvantages.

It is of equal concern that such payments should not escape taxation altogether. According to recital 3, those payments should "*...be taxed once in a Member State.*"

The scheme consists of exempting interest and royalty payments from taxation at source, whether by assessment or by withholding tax, while attempting to ensure that the beneficial owner of the payments is taxed in its MS of residence or, in the case of permanent establishments (PEs), in the MS where they are situated. The Directive provides for a refund procedure for those cases where tax has been withheld at source.

By taxing the beneficial owner in the MS of residence – in the case of PEs, in the MS where they are located – it is guaranteed that such income is taxed in the same jurisdiction where the related expenditure is deductible (i.e., the cost of raising capital in the case of interest income, and research and development expenditure in the case of royalties).

3.2. Implementation

Most of the 20 MS covered by the survey appear to have implemented the Directive within the legal deadline. Of those MS which did not do so, all but one made the national implementing rules applicable retroactively from 1 January 2004.

As regards the practical implications of the Directive, the survey notes that ten MS do not at present levy withholding tax on outbound interest payments (with a further two MS granting broad exemptions), and that six MS do not levy withholding tax on royalty payments (an exception, in the case of one MS, for patent royalties).

It should be noted in this context that the Directive is relevant even for those MS that do not levy withholding taxes (or tax by assessment) on interest or royalty payments, inasmuch as Articles 4 and 5 limit the discretion of all MS to recharacterise interest or royalty payments as profit distributions and levy taxes thereon.

3.3. Specific issues of interpretation and application

3.3.1. Articles 1(1), 1(4) and 1(5) – 'Beneficial owner'

The beneficial ownership condition aims at ensuring that relief under the Directive is not wrongfully obtained through the artificial interposition of an intermediary.

While there are differences of wording between the beneficial ownership criteria for companies and PEs, respectively, the key difference lies in the reference to

⁴ The derogations for Bulgaria and Romania are provided for in the Act concerning the conditions of accession of the Republic of Bulgaria and Romania and the adjustments to the Treaties on which the European Union is founded, annexes VI, number 6, and annex VII, number 7, OJ L 157, 21.6.2005, p. 289 and 329.

"...income in respect of which that permanent establishment is subject...to one of the taxes...". The Directive here makes explicit that the payments as such must be taxed in the hands of the beneficial owner.

The MS covered by the survey have adopted different approaches in respect of the beneficial ownership criteria. With regard to companies, some MS have chosen not to transpose the Article 1(4) definition at all, others have relied on domestic definitions, and yet another group of MS have transposed it with deviations. As regards PEs, some MS have chosen either not to transpose Article 1(5) at all, or to transpose it with national variations.

Those differences of approach could lead to relief being denied in one MS, but being granted, in identical circumstances, in another. Notwithstanding comments from some MS to the effect that this issue is essentially one of case-by-case assessment, the fact remains that the term as used in the context of the Directive is one of Community law. Its interpretation must be uniform throughout the Community. The co-existence of 27 potentially different interpretations would undermine the effectiveness of the Directive.

Possible solutions include developing guidance through discussion in a technical working group or amending the definitions with a view to make them more precise.

3.3.2. *Article 1(3) – PE – 'Tax-deductible expense'*

In the case of payments made by PEs, the obligation of the source State to refrain from taxing is made conditional on such payments being a tax-deductible expense for the payer.

It is clear from the context that the purpose of the 'tax-deductibility' requirement is to ensure that the benefits of the Directive accrue only in respect of those payments that represent expenses which are attributable to the PE. However, on its wording the provision would also apply to cases where deduction is denied on other grounds.

While the IBFD found no cases in the surveyed MS of relief having been denied on the grounds that the payment was a non-deductible expense, it cannot be excluded that such cases may occur in future, and that the host state of the PE might in that situation impose a withholding tax on the payment.

In order to avoid an unjustifiable difference of treatment as between a subsidiary and a PE, consideration might be given to rewording Article 1(3) in order to make it more precise.

3.3.3. *Article 1(10) – Holding period*

Eleven of the 20 surveyed MS have availed themselves of the option provided for by Article 1(10) to impose a minimum holding period as a condition for enjoying the benefits of the Directive. According to the survey, three of these MS require this condition to be satisfied at the time of payment, with no possibility for a subsequent fulfilment of the condition to be taken into account retroactively.

The latter requirement appears to be inconsistent with the purpose of the Directive in general and of Article 1(10) in particular, and with the relevant ECJ case law. In the *Denkavit* case, concerning the holding period option provided for by Article 3(2) of the Parent-Subsidiary Directive, the Court found that as a derogation from the principle of exemption from withholding taxes laid down by that Directive, the

holding period option was to be interpreted strictly.⁵ It further noted that the provision in issue was “*aimed in particular at counteracting abuse whereby holdings are taken in the capital of companies for the sole purpose of benefiting from the tax advantages available and which are not intended to be lasting*”⁶.

The above findings have direct relevance for the interpretation of Article 1(10) of the Directive. As in the case of Article 3(2) of the Parent-Subsidiary Directive, Article 1(10) constitutes a derogation from the principle of exemption from withholding taxes, and is therefore to be interpreted strictly. It also shares the same purpose as Article 3(2), i.e. to counteract abusive enjoyment of the benefits of the Directive through temporary, purely tax-motivated holdings. That purpose is achieved if the holding is maintained for the required minimum period, regardless of whether that period has already come to an end at the time of payment or whether it comes to an end only at some later time, such as the date on which an application for relief is submitted.

The ECJ has held that MS are not obliged to grant the exemption from the beginning of the holding period without being certain of being able to recover the tax if the holding were not maintained for the minimum period or to grant the exemption immediately on the basis of a unilateral undertaking by the parent company⁷. However, this judgment was delivered before the Council amended Directive 76/308/EEC in order to extend the scope of administrative cooperation in the recovery of claims to taxes on income⁸. This new legal context could modify Member States' obligations under the Directive since they now have new tools to recover tax debts.

3.3.4. Article 2 – ‘Interest’ and ‘Royalties’

The survey did not reveal any significant discrepancies between the Article 2(a) definition of ‘interest’ and those relied on in the context of national legislation transposing the Directive. Nor do there appear to be any obvious differences between the Article 2(a) definition and that of Article 11 of the OECD Model Tax Convention (MTC) that might be of relevance for the application of the Directive.

According to the survey, two MS applied a narrower definition of royalties than that contained in Article 2(b). Thus, some royalty payments from those MS could at that time have been subjected to withholding tax, depending on the content of national law and relevant double tax conventions (DTCs). Since the survey was finished, one of the MS has subsequently amended its legislation in order to align its domestic definition on that of the Directive.

The definition contained in Article 2(b) is precise and unambiguous. It follows that MS can depart from that definition only to the extent that by so doing they grant relief that is identical to, or more generous than, that prescribed by the Directive.

⁵ Judgment of 17.10.1996 in Joined Cases C-283/94, C-291-94 and C-292/94 *Denkavit International BV a.o. v Bundesamt für Finanzen*, paragraph 27.

⁶ Paragraph 31.

⁷ *Denkavit*, paragraph 33.

⁸ Council Directive 2001/44/EC of 15 June 2001 amending Directive 76/308/EEC on mutual assistance for the recovery of claims resulting from operations forming part of the system of financing the European Agricultural Guidance and Guarantee Fund, and of agricultural levies and customs duties and in respect of value added tax and certain excise duties, OJ L 175, 28.6.2001, p. 17–20.

3.3.5. Article 3(a) – 'Company of a MS'

3.3.5.1. The Annex – List of entities

Several MS have chosen to extend the benefits of the Directive to payments from a broader range of entities than those listed in the Annex, while maintaining the Annex requirements in respect of the recipients of the payments.

3.3.5.2. Transparent entities

It is conceivable that one or more of the entities listed in the Annex could be regarded as fiscally transparent by a MS other than that in which the entity is registered or incorporated.

The Directive does not contain any provision allowing MS to 'look through' non-resident qualifying⁹ entities. It follows that a MS has no legal basis for refusing to apply the Directive to a non-resident entity which meets the requirements of Article 3.

However, even if it were permissible to apply a look-through approach, the logic of that approach would require the MS in question to extend the benefits of the Directive to the partner/shareholder. That view would be consistent with the position taken in the OECD Partnership Report and the Commentary on Article 1 of the MTC¹⁰.

3.3.5.3. Place of effective management

Three of the surveyed MS appear to require, as a condition for granting exemption, that the company receiving a payment should be subject to corporation tax in the MS in which it has its place of effective management. This could lead to a denial of the benefits of the Directive in a situation where, for instance, both the MS in which the company is incorporated and that in which it has its place of effective management rely, in their domestic legislation, on the place of incorporation as the relevant factor for determining tax residence.

There is no support in the text of the Directive for imposing one tax residence criterion in preference to another. If the company is resident in one MS only, it matters not whether the criterion applied by the MS of residence is the place of incorporation or the place of effective management. If the company is dual resident, the tie-breaker rule of the relevant DTC will usually determine residence on basis of the 'place of effective management' criterion. In the latter situation, it may be reasonable to expect that the company should be "*subject to one of the following taxes without being exempt*" [Article 3(a)(iii)] in the MS in which the company has its place of effective management.¹¹

3.3.5.4. Subject-to-tax requirements

While most MS appear to apply a 'subjective' subject-to-tax requirement – i.e. it applies to the company as such, rather than to the specific interest or royalty payment

⁹ I.e. that meet all of the criteria of Article 3.

¹⁰ See in particular paragraphs 6.4 and 6.5.

¹¹ A position that could conceivably be challenged on the grounds that in a case where a PE is the recipient of an interest or royalty payment it should suffice that the company is subject to tax in the MS of the PE on profits attributable to the latter.

– some MS require that the payment itself should be subject to tax (an 'objective' subject-to-tax requirement).

According to the survey, one MS requires that the company should not have an option of being exempt. That MS furthermore requires that the company should be subject, in its MS of residence, to a tax that is of the same or similar character as the income tax in the first MS.

There is no support in the Directive for either requirement. On the contrary, the conditions of Article 3(a) are exhaustive, thus leaving no scope to impose further conditions and restrictions.

3.3.6. *Article 3(b) – 'Associated company'*

3.3.6.1. Holding threshold

According to the survey, no MS had relaxed the 25% direct minimum holding threshold, although one MS accepts indirect holdings. However, several MS had either moved from a 'capital' criterion to a 'voting rights' criterion, or allowed the alternative use of either criterion.

The survey found that one MS requires that both criteria, 'capital' and 'voting rights', be satisfied simultaneously. There is no support in the Directive for such a dual requirement.

3.3.6.2. Companies 'involved'

One MS has extended the scope of relief available under the Directive by dispensing with the requirement that the common parent in the situation described in Article 3(b)(iii) should be EU-resident. MS can be more generous than the Directive.

3.3.7. *Article 3(c) – PE – Definition*

The definition of a PE is clearly modelled on that of Article 5 of the OECD MTC, but without reproducing the list of examples and exceptions contained in Articles 5(2) to 5(7).

The fact that the Directive's definition differs somewhat from that of Article 2(2) of the Parent-Subsidiary Directive, and that neither definition reproduces exactly Article 5 of the OECD MTC, may create a situation of legal uncertainty, in particular concerning the situation of dependent agent PEs.

When implementing the Directive most MS have chosen to rely on the general PE definition contained in their respective domestic tax legislations. However, five MS have introduced a specific definition for the purpose of implementing the Directive.

3.3.8. *Article 4(2) – Exclusion of payments as interest or royalties*

Article 4(2) is a transfer pricing provision. As is clear from the commentary on the Article contained in COM (1998) 67 final, it is also intended to be a thin capitalisation provision. The commentary also argues that any amount reclassified as a profit distribution should be granted the benefits of the Parent-Subsidiary Directive¹².

The survey found that one MS would deny the benefits of the Parent-Subsidiary Directive for interest and royalty payments reclassified as hidden profit distributions,

¹² Cf. the opinion of AG Mischo of 26.9.2002 in Case C-324/00 *Lankhorst-Hohorst*.

on the grounds that under domestic case-law such distributions cannot be regarded as dividends. However, that MS finds itself unable to charge withholding tax if there is a DTC, since the dividend Article of the DTC would not apply.¹³

There is a need for further reflection regarding the tax treatment of excess amounts of interest or royalties, whether or not reclassified as profit distributions. Depending on the circumstances, there could conceivably also be a question of discrimination vis-à-vis the treatment of similar domestic payments.

In this context it should be noted that the Court has found that the discriminatory application of thin capitalisation provisions involving a fixed debt/equity ratio, with no let-out clause, constitutes a disproportionate, and therefore unjustifiable, restriction of the freedom of establishment.¹⁴

3.3.9. Article 5 – Fraud and abuse

Several MS appear to interpret Article 5 as authorising the denial of relief in cases where the receiving company is controlled by a third-country resident.

One MS appears to deny the benefits of the Directive to a receiving company of another MS which is owned or controlled by a person ordinarily resident or domiciled in the first MS.

Article 3(b) requires that "*holdings must involve only companies resident in Community territory*". The Directive does not however stipulate that a parent company receiving an interest or royalty payment from its part - or wholly- owned subsidiary must be controlled by an EU resident (or by a resident of a MS other than that of the subsidiary) in order for the payment to qualify for relief.

Article 5 must moreover be interpreted in the light of the relevant ECJ anti-abuse case-law, which requires anti-abuse measures to be appropriate and proportionate.¹⁵ Domestic legislation or a DTC provision that denies relief on the sole grounds that the parent company is controlled by a third-country resident – or by one of its own residents – is unlikely to meet the proportionality test, as it does not "*have the specific purpose of preventing wholly artificial arrangements*".¹⁶

It should be recalled that the 'beneficial owner' condition of Article 1 is specifically designed to tackle artificial conduit arrangements. It may therefore be doubted whether a company that satisfied the 'beneficial owner' test, could be considered an artificial conduit when applying Article 5.

¹³ This may not be beyond doubt. In a reservation on Article 10(3) of the OECD MTC, the MS in question reserves "*the right to amplify the definition of dividends in paragraph 3 so as to cover all income subjected to the taxation treatment of distributions*". A payment need not therefore necessarily qualify as a 'dividend' under the domestic law of that MS in order to be considered a 'dividend' when applying Article 10(3).

¹⁴ Case C-105/07 *Lammers*, paragraph 32. See also Case C-524/04 *Thin Cap Group Litigation*, at paragraph 92.

¹⁵ E.g. judgment of 17.7.1997 in Case C-28/95 *Leur-Bloem v Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2*, paragraph 44.

¹⁶ E.g. judgment of 13.3.2007 in Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue*, paragraph 79.

3.4. Issues not addressed by the survey

3.4.1. *Intra-company payments*

The scope of the Directive is currently limited to payments between separate legal entities. Thus, it does not cover the intra-company situation, for instance actual or notional payments between a head office and a PE, or between two PEs of the same company.

In the context of the OECD work on the attribution of profits to PEs, the question has arisen whether, under DTC, the source state (usually the state of the PE) would be entitled to levy a withholding tax, or other form of taxation at source, on notional interest or royalty payments to the head office or other PE of the same company.

The matter is still under debate, but some OECD countries have indicated that they would be minded to impose a withholding tax on the above payments.

Taxation at source on intra-company payments would create disadvantages for cross-border investment similar or identical to those that prompted the adoption of the Directive. It would therefore seem appropriate to consider extending the scope of the latter to cover such payments.

3.4.2. *Holdings*

The threshold: Article 3(b) of the Directive currently stipulates that ‘holdings’ within the meaning of that provision should meet or exceed a threshold of 25% of capital or voting rights. Under Article 3 of the Parent-Subsidiary Directive, which contains a similar provision, the threshold for ‘holdings’ has gradually been reduced from 25% to currently 10% of capital or voting rights as of 2009 (cf. also Article 7(2) of the Merger Directive).

Thus, even though all three EC company tax directives share the aim of creating conditions analogous to those of an internal market, a company group for the purposes of the latter two directives remains something less than a company group under the Interest and Royalties Directive, thereby increasing the planning and compliance costs of companies involved in cross-border operations.

The difference between thresholds may produce incongruous results, for instance in the context of a reclassification of an interest or royalty payment as a profit distribution. An interest or royalty payment between companies associated through a ‘holding’ of at least 10%, but less than 25%, would not qualify for relief under the Interest and Royalties Directive, but would qualify for relief under the Parent-Subsidiary Directive if reclassified as a profit distribution.

Indirect holdings: the scope of the Directive is currently limited to direct holdings, while that of the Parent-Subsidiary Directive has no such limitation. Since both directives share the same purpose – i.e. to eliminate double taxation – there is no obvious justification for this difference.

Extension of the scope: while the elimination of inconsistencies in respect of thresholds and direct/indirect holdings would represent a significant improvement on the existing situation, it can be deduced from Article 8, read in conjunction with recitals 2, 4 and 9, that it was the intention that the Directive should eventually encompass unrelated undertakings, and that the current limitation to associated undertakings should be seen only as an experimental first step. It is self-evident that international double taxation, burdensome administrative formalities and cash-flow

problems, as cross-border obstacles to transactions between related companies, are also present in the case of payments between unrelated parties.

As regards royalty payments, an extension of the scope of the Directive to unrelated undertakings would be consonant with the Article 163 EC objective of “...*strengthening the scientific and technological bases of Community industry and encouraging it to become more competitive at international level...*”

It should also be noted that extending the scope would be consistent with Articles 11 and 12 of the OECD MTC, which make no distinction between related and unrelated undertakings.

Finally, the budgetary impact of an extension would have to be considered. However, it should be noted that it is likely to be limited, since most MS already waive their taxing rights partly or wholly, either through domestic legislation or in their DTCs with other MS.

4. CONCLUSION

While the survey indicates that overall implementation has been satisfactory, it has also highlighted a number of cases of questionable transposition and interpretation, e.g. in respect of the minimum holding period, tax residence of the beneficial owner, holding threshold, reclassification of hidden profits, the interrelation between the Interest and Royalties Directive and the Parent – Subsidiary Directive and the fraud and abuse clause.

It is also clear that further discussion and guidance in respect of key Directive concepts may be necessary in order to achieve uniformity of interpretation, and reduction in legal uncertainty. There is a need to reflect on the implications of a non-uniform implementation and interpretation of the 'PE' concept in the context of the Directive, and of having a PE definition that diverges from that of Article 5 of the MTC, e.g. with regard to the possible exclusion of agency PEs.

As to amendments that might improve the operation of the Directive, a rewording of Article 1(3) could remove what may be seen as an unjustifiable discrimination between subsidiaries and PEs. And in terms of coherence and consistency, aligning the holding criteria of the Directive with those of the Parent-Subsidiary and Merger Directives should clearly be an urgent priority. Consideration might now be given to extending the scope of the Directive to unrelated undertakings, with a view to assess its potential to further the Lisbon objectives.