European Commission Publishes Inception Impact Assessment on a New EU System for the Avoidance of Double Taxation and Prevention of Tax Abuse in the Field of Withholding Taxes

In this note, the authors discuss the aim of the impact assessment and provide context to the initiative both in terms of previous work performed and the current state of play within the European Union.

1. Introduction

The European Commission published, on 28 September 2021, an Inception Impact Assessment (Impact Assessment) titled New EU system for the avoidance of double taxation and prevention of tax abuse in the field of withholding taxes (WHT).1

This Impact Assessment is the latest in a series of initiatives the objective of which is to simplify and improve WHT relief procedures for cross-border investors. The aim of the Impact Assessment is to inform and gather feedback from citizens and stakeholders, in particular, their views on the suggested policy options, which are:

- improving WHT refund procedures to make them more efficient;
- establishing a full-fledged common EU relief at source system; and
- enhancing the existing administrative cooperation framework to verify entitlement to tax treaty benefits.

This initiative falls within a wider objective, that of removing barriers to a proper functioning Capital Markets Union.2

2. Background

Capital market participants, investors, Member States and European Institutions have, for a long time, identified WHT relief procedures as a potential deterrent to cross-border investment and hence an important barrier to a truly integrated European Capital Markets Union.

The coexistence of multiple country-specific sets of rules, each with their own procedural and documentation requirements, overlaid with divergent revenue authority approaches and misaligned beneficial ownership interpretations, has led to the complex European WHT landscape we find ourselves in today.

There is little to no uniformity in WHT relief claim processes, with different forms and processes required in each country of investment. On one side of the spectrum, some Member States allow non-domestic financial intermediaries to file reclaims via electronic XML bulk submissions, aggregating claims and data for multiple beneficial owners. On the other side of the spectrum, some Member States only allow single beneficial owner paper-based claims filed by a domestic financial intermediary. In some markets, non-domestic information and withholding agents play a central role in the WHT refund process, whilst, in others, the presence of a local agent is needed, and investors are effectively prevented from seeking help from their home-country financial institutions.3 In certain markets, the WHT refund process has been seen as so difficult that, not only investors, but even institutional participants, have decided not to file claims because the administrative cost significantly outweighs the potential benefit. The economic cost of this inefficiency can be seen in a study by the Commission. This study found that the overall cost of WHT refund procedures was estimated to be EUR 8.4 billion per year.4

In addition to the deterrent effect these often cumbersome, complicated and inefficient (and manual) processes have on cross-border investments in the European Union,


they increase the risk of human error and are prone to abuse. This increases the risk of fraud and refunds being paid to non-entitled parties or even multiple refunds being paid for one taxable event. This has been evidenced by several high-profile cases that have fuelled the debate even further. The well-known cum-ex and cum-cum scandals have resulted in an estimated overall net loss of EUR 55 billion.5

In the wake of these scandals, tax authorities and policymakers are trying to manage their risk. Their approaches are not, however, aligned, with some tax administrations introducing additional documentation requirements to establish reclaim eligibility (either imposed on the financial intermediaries interposed in the ownership chain who are required to extract and analyse trade data or on the end investor); and others increasing the volume and depth of WHT audits. This fragmented approach has further increased the complexity and associated cost investors and intermediaries are facing whilst pursuing WHT claims.

This is not, however, new. Both the problem and the policy options proposed by the Commission in this Impact Assessment are well known and have been the subject of longstanding debate, arguably sparked as early as the beginning of this century with the Giovannini reports.6

3. The Inception Impact Assessment’s Proposed Policy Options Discussed against the Backdrop of an Historic Overview – What Is New?

3.1. Introductory remarks

In what follows, the authors briefly discuss the policy options proposed by the Commission in the recent Impact Assessment in light of the various initiatives taken during the past two decades.

3.2. Option 1: Improving WHT refund procedures to make them more efficient

In its 2009 recommendations on WHT relief procedures, the Commission further invited the Member States to consider alternative means of soliciting and retaining documentation and specifically noted that Member States could consider allowing information and withholding agents to transmit and archive information and documentation by electronic means.7

Commitment no. 4 in the Commission’s 2017 Code of Conduct on WHT also refers to the digitalization of WHT procedures.8 It describes digitalization of the reclaim process as the adoption of or increase in the use of digital or computer technology. The Commission refers to electronic forms to be filled in, electronic submission or upload of claims and allowing for the possibility of bulk claims in respect of multiple beneficial owners at once.

Whilst, in recent years, there has undoubtedly been a shift in a number of Member States’ practices to more digitalized reclaim processes (for example, by accepting or requiring claims to be uploaded in XML format on a revenue authority’s portal), the consensus amongst market participants is that the entire end-to-end process from documentation to reclaim filing is generally still very paper based and therefore administratively heavy – furthermore this administrative burden has been exacerbated by the current pandemic.9 In a global and complex financial landscape, it is common for there to be a long and complicated chain of intermediaries between the withholding agent and the end investor. A typical ownership chain includes a bank (that has the relationship with the end investor), a global custodian that manages the safekeeping of the assets and performs asset servicing (income collection, corporate action processing, tax service), a local custodian in the source market to manage the local infrastructure and, potentially, even another intermediary acting as withholding agent.10 As the paperwork needs to flow through this complex and multi-jurisdictional network, the risk of abuse could potentially increase, which may have a deterrent effect on investment decisions.

This is now reiterated in the first policy option outlined by the Commission in its Impact Assessment, which suggests that improving the WHT refund procedures to make them more efficient can be achieved through digitalization of the current paper-based relief processes.

As tax authorities become increasingly more digital, digitalization of the withholding refund process will be a natural and organic next step. Allowing for digital reclaim submission will reduce compliance costs for capital market participants and tax administrations. Furthermore, this will also allow tax administrations to better review and reconcile withholding tax reclaim information with information reporting submitted by financial intermediaries in relation to income payments and WHT paid, which would reduce the likelihood of fraudulent claims and improve the efficiency of the process as a general matter.

At the time of writing this article, the European Parliament had just released its draft report on the European Withholding Tax framework. The report includes three main objectives, one of which is the removal of barriers to cross-border investment in the single market. The report specifically mentions that digitalizing refund procedures and improving cooperation between national administrations could reduce the administrative burden and uncertainty.

More importantly, in the report, the Parliament calls on the Commission to propose measures to link tax reclaims to the underlying distribution of dividends or to entrust a single entity with responsibility for collecting the WHT and issuing the relevant certificate. Whilst these proposals are essential in the fight against fraudulent WHT schemes, they could also be a first step in a move to digitalize the entire ownership chain of securities, with the result that all investor and trade data would be digitalized and retained in a central repository accessible to all capital market participants playing a role in income distribution and WHT determination and remittance.

Whilst both the Parliament, in its recent draft report on the EU WHT Framework, and the Commission, earlier in its 2009 Recommendations, link the digitalization journey to the reclaim process, the authors believe there would be merit in an all-encompassing integrated approach, whereby relief at source and digitalization go hand in hand.

### 3.3. Option 2: Establishment of a full-fledged common EU relief at source system

In the Giovannini reports, it was already suggested that a significant barrier to an efficient post-trading environment in the European Union is the complexity of the various EU Member States’ co-existing, but not synchronized, WHT legislative procedures. The 2001 and 2003 reports specifically noted the lack of common procedures for claiming tax treaty benefits and the inability of foreign intermediaries to offer relief from WHT at source outside their home jurisdiction as primary obstacles to an efficient European clearing and settlement system.

In other words, the Giovannini reports already suggested that a potential solution could be what is suggested by the Commission today, i.e. the establishment of a full-fledged common EU relief at source system whereby WHT obligations (and liabilities) are imposed on non-domestic intermediaries. This might involve non-domestic financial intermediaries being authorized to levy WHT on behalf of foreign tax authorities.

In its 2009 recommendations on WHT relief procedures, the Commission also recognized that the preferred way forward was a relief at source system with close cooperation and exchange of information between all intermediaries interposed in the ownership chain of the securities. This proposal undoubtedly has merit, not only from an administrative ease perspective but also from the perspective of reducing potential revenue loss due to fraudulent transactions resulting in multiple refunds in respect of the same underlying taxable event.

It is generally understood that a move towards a widely adopted relief at source system, as opposed to a reclaim-based system, would be a step forward towards simplification and alignment. Furthermore, there would clearly be benefits for investors in terms of the time value of money if a reduced rate of WHT were to be applied upon payment and not after the event by way of reclaim.

The benefits of a centralized relief at source model were already discussed in the Giovannini reports, the Commission’s 2009 WHT recommendations and the European Commission’s 2017 Code of Conduct on WHT, which is a non-binding document calling for voluntary commitments by Member States and should be considered as a compilation of approaches to improve the efficiency of current WHT procedures.

In June 2020, the European Union’s High Level Forum on the Capital Markets Union, a working group, published a report in which it invited the Commission to set out EU law common definitions, common processes and a single form relating to WHT relief at source procedures and their streamlining. In order to alleviate the burden on stakeholders, it was proposed that the Commission make a proposal to introduce a standardized system for WHT relief at source, based on authorized information agents and withholding agents.

In response, the Commission committed to proposing a legislative initiative introducing a common, standardized, EU-wide system for WHT at source, accompanied by an exchange of information and cooperation mechanism among tax administrations.

Such an integrated EU-wide system could indeed create uniformity in processes (such as one standardized beneficial owner declaration/self-certification, as opposed to a myriad of different forms and a uniform XML-based information and payment reporting process) and a level playing field by allowing all intermediaries established within the European Union to act as withholding agents in all Member States.

Studies have shown that implementing relief at source procedures has positive spill-over effects, such as increased efficiency and reliability of refund processes, a decrease in

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13. Supra n. 7.
14. Supra n. 8.
the administrative burden and the freeing up of resources, both at the level of financial intermediaries and the tax authorities, allowing them to shift their focus to tasks that generate more added value.\(^{17}\)

As discussed further below, an integrated relief at source system, together with an effort to digitize the WHT process and embrace new technologies, will be the way forward in an increasingly globalized financial landscape.

### 3.4. Option 3: Enhancing the existing administrative cooperation framework to verify entitlement to tax treaty benefits

This option envisages a reporting and subsequent mandatory exchange of beneficial owner-related information, on an automated basis, to reassure both the residence and source country that the correct level of taxation has been applied to the non-resident investor. This falls squarely within the broader tax landscape, which has been characterized by a move towards tax transparency and automatic exchange of information, with recent initiatives being the Common Reporting Standard and the multiple extensions to the EU framework on exchange of information laid down in the Mutual Assistance Directive (2011/16).\(^{18}\)

An exchange of beneficial owner-related information (potentially supplemented by trade and income data) on an automated basis between tax authorities and potentially market participants should be seen as a means to an end and not an end in itself. This proposed exchange of beneficial owner data should be considered within the framework of a more integrated, digitalized relief at source system whereby all participants in the network have access to and exchange this information on an automated basis.

### 4. Next Steps and Way Forward

It is clear that, over the past two decades, streamlining and synchronizing the European WHT framework has been high on the agenda of lawmakers, revenue authorities, financial intermediaries and cross-border portfolio investors.

Both the problem and the possible solutions are well known and have been articulated numerous times. Whilst some improvements have been made in a number of Member States, the overall status remains unsatisfactory, with barriers and obstacles still in place preventing WHT claims from operating efficiently.\(^{19}\)

The question now is whether the policy options the Commission has proposed in its Impact Assessment are capable of receiving the support needed to end the status quo and finally move towards a truly integrated and efficient capital market union with a level playing field for both source country and non-source country financial intermediaries, allowing seamless cross-border portfolio investment, minimizing foregone tax relief and maximizing cross-border investment, all in an environment allowing for adequate safeguards and controls to reduce the risk of tax abuse.

The authors believe that these policy options, in conjunction with the proposals laid down in the EU Parliament’s draft report, are a move in the right direction, which the authors believe should involve a unified legislative relief at source framework, underpinned by a technology solution allowing for seamless information exchange of relevant data between relevant participants.\(^{19}\)

Whilst the authors acknowledge and support the reference to digitization, there is room to make an evolutionary jump and consider new emerging technology, such as distributed ledger technology (DLT). Some of the features that exist with DLT could help investors, intermediaries and governments achieve their goals. Indeed, it is vital that any solution work for all three constituents.\(^{20}\)

### 5. Conclusion

Against the background of a desire to create a more efficient capital market, in conjunction with ever-increasing digitalization, and exacerbated by the challenges but also opportunities emerging from the COVID-19 pandemic, now more than ever the time is ripe for change.

Whilst the policy options proposed in the Impact Assessment broadly reiterate what has been proposed during the past two decades, these are steps in the right direction to develop the future WHT model, which should be an EU-wide synchronized relief at source framework characterized by uniformity in documentation requirements and underpinned by bold and emerging technology solutions. The question will be whether or not the political will and support exist to turn this initiative into an outcome capable of being adopted by the Member States.

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17. Supra n. 3.
19. Supra n. 11