

TAXATION OF FINANCIAL SERVICES IN THE EUROPEAN UNION

Summary: The European Commission has a comprehensive strategy for the EU's future taxation policy. Tax policy is intended to support broader EU policy objectives such as the goal set by the Lisbon European Council of making the EU the most competitive economy in the world by 2010. But while the Commission believes that a large measure of harmonisation is necessary in indirect taxation, in other tax fields tax co-ordination does not imply harmonisation of tax rates. A key tax policy initiative is the Monti tax package, which aims to ensure a minimum effective level of savings taxation within the EU and to address concerns about forms of tax competition between member countries which the EU Commission regards as unfair. The commission's plan for integrating financial services markets by 2005 are proceeding more or less according to the timetable set out in 1999. Incompatibilities in tax regimes of the member countries will become increasingly visible obstacles to cross-border provision of financial services. For example, there has been progress in agreeing an approach on the draft Pensions Directive, but national taxation rules remain a key obstacle to building an integrated single market for pensions. The commission has stated that certain national tax rules on pensions may contravene rights of free movement of labour and capital as guaranteed under the EC Treaty, and that it may ensure effective compliance through the European court of Justice. Similar concerns about tax obstacles exist in other areas, such as the Collective Investment Undertakings (UCITS) industry, where promoters of these funds are discouraged by national tax rules from selling UCITS in particular EU countries. Preferential tax incentives forms of long-term savings may also be acting as a barrier to a single market. Such tax obstacles may stand in the way of a fully functioning single Market for financial services.

Introduction

The European Union's financial services industry is being transformed by the interaction of several phenomena, including the wider process of globalisation, the harmonisation of the regulatory framework across the Union and the implementation of financial reforms in the Member States. The combined effect of these developments is to integrate progressively the EU financial services industry, a process that is reflected in more homogeneous markets, a wave of consolidation among intermediaries and the emergence of new and innovative products and techniques. Since 1999, the successful introduction of the Euro has also helped in this transformation by eliminating exchange risk for financial flows across most of the Union.

An important influencing factor in the drive towards more integrated tax systems is the Lisbon process. The Lisbon European Council (March 2000) set an ambitious strategic goal for the EU, namely "... to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion". EU tax policy is seen as being an important factor underpinning the Lisbon goals, and supporting the continued development of the Internal Market by allowing member states to compete on a level playing field. EU enlargement will pose further challenges to EU tax policy co-ordination. The enlarged Union will be more heterogeneous in terms of its member's national interests. The new members are different in their economic structure. Their tax systems are shaped in accordance with their stage of economic development, using taxes as a means to increase their attractiveness for badly needed foreign investment. Tax breaks and special regimes are widespread. A Union of 27 members may slow the EU's decision-making process unless the European Convention or another forum manages to simplify it. All this means that

the EU, while reaping the substantial benefits of enlargement in numerous areas, will be in a worse position to tackle tax issues.

EU Commissioner Bolkestein has said that while a high degree of harmonisation is necessary in indirect taxation, direct tax systems require only limited harmonisation. In the area of the taxation of companies and the taxation of financial capital, which may have direct effects on the creation of an Internal Market, Member States have become more favourable to the idea of increased tax co-ordination. However, the EU Commission has no intention of harmonising company tax rates, but is rather focussing on establishing a harmonised approach for providing companies with a consolidated corporate tax base for their EU-wide activities. This is in order to address a number of tax obstacles that hamper cross-border economic activity in the internal market, since the co-existence of 15 separate sets of tax rules for determining the basis of assessment in the internal market causes numerous problems for the taxation of intra-group transactions ("transfer pricing") and increases the risks of double taxation. The EU Commission also believes that tax systems must be made simpler and more transparent. In this context it argues that while unfair tax competition should be addressed, some degree of tax competition within the EU may be inevitable and may contribute to pressure for lowering tax rates. Indeed, a recent Centre for European Policy Studies (CEPS) report has stated that the assertion that tax competition is harmful finds scant support in the academic literature or in the facts. Taxes are not the main driving force behind foreign investment, but only one of the factors, meaning that it is difficult to isolate taxes in an overall process of competition for foreign investment. In general terms, tax competition is seen as beneficial as it forces policy-makers to provide public services efficiently. (*The Future of Tax Policy in the EU*, CEPS, 2000).

The Financial Services Action Plan comprises a series of policy objectives and specific measures to improve the Single Market for financial services by 2005, including the elimination of tax obstacles and distortions that affect, firstly, cross-border competition amongst financial services providers, and secondly, the location decision of financial services providers. The EU Commission considers that it would be technically unbalanced and politically difficult to achieve the full realisation of a Single Market for financial services unless there is a parallel process of tax co-ordination. A key focus of the EU Commission is therefore the adoption of the three elements of the Monti Tax Package, which the EU believes will help to address 'unfair' tax regimes to both cross-border competition and location of financial services providers.

The EU Commission has also issued a Communication on taxation barriers to cross-border provision of pensions, which aims to put an end to discrimination involving occupational schemes established in other Member States. It covers the preferential treatment of domestic schemes and in particular the more favourable rules concerning the deductibility of contributions or taxation of benefits, and recommends automatic exchange of information between Member States on the recovery of taxes applied to cross-border pension benefits. The following two sections consider key taxation policy issues affecting the financial services industry in the EU. Firstly, the EU Tax Package to address unfair tax competition in the EU is discussed. Secondly, taxation barriers to cross-border provision of savings products are assessed.

1. The Monti tax package

In April 1996 ECOFIN set up a High Level Group on taxation, (the "Monti Group") in order to develop measures to provide a more effective defence against the loss of national fiscal

sovereignty through 'unfair' tax competition. The Monti tax package, which was agreed to in principle by ECOFIN in 1997, includes three elements:

The first element of the package - the Code of Conduct on business taxation - establishes criteria for identifying 'harmful' tax measures affecting the location of business activity within the EU. Members committed to rolling back existing 'harmful' measures, and to a standstill on introduction of any new 'harmful' measures. ECOFIN established a Code of Conduct Group to identify 'harmful' measures, and the Group has since identified 66 taxation measures in the EU which had been deemed to be harmful. These included a number of regimes relating to the financial services sectors of EU member states, including Ireland's International Financial Centre in Dublin, Italy's Trieste Financial Services and Insurance Centre, Luxembourg Finance Companies and Finance branches, and Dutch Intra Group Finance Activities. As a matching commitment to the political agreement to the Code, many Member States urged the Commission to re-examine its policy in the field of fiscal State aid and to make full use of its powers under the Treaty rules in order to combat harmful tax competition, therefore in the framework of the Code of Conduct, the Commission also committed itself to publishing guidelines on the application of State Aid rules to measures relating to direct business taxation. The new guidelines aim to link the provisions of the Treaty and related rules on State aid to the fight against harmful tax competition.

The second component of the package was the commitment to ensure a minimum level of effective taxation of savings within the EU, which was originally approved by ECOFIN on the basis of a co-existence model of information exchange or withholding tax. The Commission presented a proposal for a 20% withholding tax on interest paid to non-resident EU citizens in May 1998. Subsequently, this proposal was altered following the Feira European Council agreement (June 2000). The new draft is based upon the principle of exchange of information between fiscal administrations, with some member countries applying a withholding tax regime over a transition period. A key issue for the EU financial services industry is whether the Directive creates an incentive for business to be conducted outside the EU if the regulatory burden involved in ensuring the effectiveness of the automatic information system is too high.

The third element of the EU tax package is a Directive which is designed to eliminate withholding taxes on payments of interest and royalties between associated companies of different Member States. Currently, withholding taxes on interest and royalty payments can give rise to double taxation and excessive administrative burdens for companies operating across frontiers.

The package has so far progressed more or less in parallel in the different areas. But some countries attach more importance to the corporate tax side, others to the savings tax element, and still others to the distortions caused by special tax regimes. Full agreement on the implementation of the tax package as a whole is to be reached at the latest by the end of 2002 according to the current EU timetable.

2. Tax barriers to a single market for financial services

Variations in the tax treatment of savings products between Member States continues to act as a barrier to creating of a genuine Single Market for financial services across the EU. These varying national tax rules can act as barriers to cross-border provision of financial services. In order to advance national public policy objectives, Member States frequently provide various

forms of tax incentives for some long-term savings products, such as pensions, life insurance savings products, or special savings schemes. Such tax privileges can also act as a form of protectionist barrier to an EU single market for financial services. This is particularly the case if these tax incentives are restricted to financial services providers resident in a member country. Two areas where tax obstacles are particularly prevalent are in the provision of pensions, and that of collective investment schemes (UCITS). The following section examines these in more detail. The problems identified can arise, *mutatis mutandis*, in other financial services fields.

2.1. Taxation barriers for Pensions

Tax treatment of occupational pensions in OECD countries

	Contributions out of taxed income or exempt	Fund income Taxed or exempt	Pension benefits Taxed or exempt	
			Annuities	Lump sum
BE	C	E	T	T
DK	E	T	T	T
DE	T/E	E	T	T/E
ES	E	E	T	T
FR	E	E	T	E
IE	E	E	T	T/E
IT	E	E	T	T
LU	T/D	T	T	T/E
NL	E	E	T	T
AT	P/C	E	P/T	
UK	T/E	E	T	E
US	E	E	T	T
CH	E	E	T	T

C: Credit D: Deductible E: Exempt T: Taxed P: Partial
 Source: van den Noord & Heady, 2001.

After a two-year long standstill, in June 2002, the Council agreed in principle on the regulatory framework for pan-European pensions. The main benefits of opening up cross-border provision of private pensions are apparent from an economic perspective: Direct benefits include greater efficiency of pension plans, a wider choice of products and improved asset allocation and possibilities of international diversification; Indirect benefits include ensuring sustainability of pensions for future generations that should revert into speeding-up of state welfare reforms. However, even if a directive is agreed, there will be little progress in practice without tax reform. This is because of the wide differences in the tax treatment of pension funds across the Union. In a speech in early 2000, Commissioner Bolkestein stated that: "... *there is the problem that Member States differ in how they tax pensions. Some give tax relief for pension contributions and then later tax pension payments. Others do not give tax relief for pension contributions but, in exchange, do not tax pension payments. You can imagine how this can lead to situations of either double taxation or double exemption for individuals who work in one State and retire to another.*"

The different frameworks hinder the creation of a single EU pensions market. Furthermore, with an increasingly mobile labour force across the Union, makes transfer of pensions difficult. Also, double taxation or exemption from taxation possibilities exist. The portability of supplementary pensions and transferability of pension capital within the EU is also subject to a number of barriers. Most governments tax the pensions benefits, leaving the contributions and the accumulation of benefits exempt. Others, such as Germany and Luxembourg, tax the

contributions, ignoring the accumulated savings and benefits (see table above). The European Commission advocates a broader acceptance of the EET principle¹, this being in practical terms the easiest as 11 Member States already apply this framework. Also, the Commission noted in its Communication on taxation barriers to cross-border provision of pensions that the EET system provides the right incentives towards making adequate retirement provisions. Furthermore, the EU Commission has taken the view that there may be cross border situations where national tax laws are contrary to the EC Treaty provisions of free movement of labour and/or capital.

Cross-border pensions and the related taxation issues are being pressed forward not only by the EC but also by legal action. A recent ECJ ruling in October 2002 (Case C-136/00, Rolf Dieter Danner) decided that income tax deductions for voluntary pension scheme contributions must not only be granted to national, but also to foreign providers based in another EU member state in order to uphold rules guaranteeing the freedom to provide services. The European Union governments should not be "restricting or disallowing (tax advantages) of contributions to voluntary pension schemes paid to pension providers in other member states." The court rejected the Finnish government's argument for non-deductibility of contributions paid to schemes operated by foreign insurers. Finland had based their argument on the need to ensure the effectiveness of fiscal controls to prevent tax evasion. Likewise, the court rejected the argument that if insurance contributions paid to schemes run by foreign insurers were deductible, residents in Member States with high income taxes would have a very strong incentive to take out insurance with institutions established in Member States with low income taxes. Fears of abuses and fiscal forum shopping, with "devastating consequences" for Member States which finance high quality social services through tax revenue, were not upheld.²

2.2 Tax barriers to Collective Investments (UCITS)³

The 1985 UCITS directive opened the way for cross-border marketing of investment funds in the EU. However, tax rules do not fall within the scope of this directive, which means that this remains a host country issue. The UCITS directive has in many respects been very successful in promoting the growth of investment funds in the EU. UCITS are established in all Member States, with total assets of nearly 41% of EU GDP at the end of 2000. Between 1995 and 2000, the sector recorded an asset annual growth rate of more than 20%. There is an emerging single market in UCITS, with more than 20,000 foreign registrations of UCITS in the EU.

However, tax barriers are one of the major reasons why the EU single market in UCITS has not developed even more rapidly. Promoters of these funds are discouraged by national tax rules from selling UCITS in particular countries. One of the consequences is that average fund sizes are smaller than might otherwise be the case, which in turn could be contributing to higher costs for fund sponsors, managers and consumers. There are significant tax barriers in some EU countries, which hinder the sale of UCITS into these markets. To the extent that national tax rules frustrate the sale of UCITS into a particular Member State, these tax rules may be challenged under the Treaty through the European Court of Justice. Similarly, tax relief given to

¹ EET stands for Exempt contributions, Exempt investment income of the pension institution, and Taxed benefits.

² The Court has also held that the need to prevent the reduction of tax revenue is not one of the grounds listed in Article 56 of the EC Treaty or a matter of overriding general interest. In addition, it held that any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State.

³ This section draws from "Discriminatory tax barriers in the single European investment funds market: a discussion paper"

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investors in a domestic UCITS but not to the same investors investing in a foreign UCITS may also be challenged in the European Court of Justice.

Significant discriminatory tax barriers to the sale of foreign UCITS in EU countries

Country	Description of discriminatory tax measure
Austria	Existing income tax regime
Belgium	i. Tax on distributions to individual investors ii. Participation exemption iii. Benefit from foreign tax credits
Denmark	Foreign Fund legislation
Finland	None noted
France	i. Plan d'Épargne en Actions ('PEA') ii. Franchise relief iii. French imputation tax system
Germany	i. Existing foreign investment fund law ii. New tax reform measures
Greece	Investment funds legislation which penalises foreign UCITS
Ireland	Taxation of Irish investors in offshore UCITS
Italy	Capital gains tax
Luxembourg	None noted
Netherlands	Reclaim of foreign withholding taxes
Portugal	Different income tax regimes for individual investors
Spain	None noted
Sweden	None noted
UK	i. Offshore fund legislation ii. UK Imputation tax system

Source: PricewaterhouseCoopers

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