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Taxation of Interest in the European Union

Leif Mutén

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Taxation of Interest in the European Union

Leif Mutén

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HWWA DISCUSSION PAPER

Edited by the Department
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Head: Prof. Dr. Hans-Eckart Scharrer

Hamburgisches Welt-Wirtschafts-Archiv (HWWA)
Hamburg Institute of International Economics
Öffentlichkeitsarbeit
Neuer Jungfernstieg 21 - 20347 Hamburg
Telefon: 040/428 34 0
Telefax: 040/428 34 451
e-mail: hwwa@hwwa.de
Internet: http://www.hwwa.de/

Leif Mutén
Professor of International Tax Law
Faculty of Law
Stockholm School of Economics
Box 6501, 11383 Stockholm SCHWEDEN
Telefon: +46 87369175
Telefax: +46 8311768
e-mail: leif.muten@chello.se

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Summary

In this paper, the author draws up the historic background to the present systems for taxing income from capital. The old schedular taxes gave way for synthetic, global income taxes, but recent developments have gone in the opposite direction. Income from capital is now often taxed separately from other income, giving rise to new problems of legal classification.

At the international level the first issue is whether the source country or the country of residence should have the right to tax. There are pros and cons for both sides, and a general attitude of *horror vacui* in the sense that double exemption is not regarded as an acceptable result.

In this context, the question of tax competition is dealt with. The paper takes the position that whereas tax competition may be useful to bring down excessive tax rates, there is no benefit in a race to the bottom. The paper points out that tax competition is harmful if it implies that a small tax haven country attracts what is an important revenue source in a country with normal taxes and makes money out of a nominal registration fee. This is likened to thieves stealing precious jewellery only to melt it down and cash in the metal value.

The proposed EU interest directive is discussed and doubts are expressed with respect to the chances of reaching agreement with low-tax countries and territories outside the EU. Other problems with a reporting system are the definition of interest for tax purposes as well as a common taxpayer identification number (TIN) system.

Zusammenfassung

In diesem Artikel wird zunächst der historische Hintergrund der gegenwärtigen Besteuerungssysteme für Kapitalerträge beschrieben. Die alten Schedularensteuern wurden von einer synthetischen Welteinkommensteuer abgelöst. Neuerdings sollen Einkünfte aus Kapital jedoch wieder getrennt besteuert werden. Dieses Verfahren verursacht Probleme. Sie können dargestellt werden am Beispiel der Reformvorschläge für die Zinsbesteuerung in der Europäischen Union.

Auf internationaler Ebene ist als erstes zu entscheiden, ob der Quellenstaat oder der Wohnsitzstaat das Vorrecht bei der Besteuerung haben sollte. Es gibt gute Gründe für beide Lösungen, aber auch Probleme, insbesondere bei der Zuordnung der Steuereinkünfte und bei der Gewährleistung einer vollumfänglichen Steuererfassung. Einigkeit besteht darüber, dass die Einkünfte nicht „doppelt freigestellt“ werden *(horror vacui).*

Bei der Wahl der Besteuerungsform ist auch zu entscheiden, ob ein harmonisierendes, grenzüberschreitendes Verfahren angewendet werden oder ob Steuerwettbewerb herrschen soll. Steuerkonkurrenz ist insoweit nützlich, als sie Steuersätze und Steuerbemessungsgrundlagen senken und damit eine langfristig in allen Staaten niedrigere Besteuerung erzwingen kann. Steuerwettbewerb erscheint freilich schädlich, wenn beispielsweise „Steueroasenländer“ Unternehmen anlocken. Dies ist immer dann der Fall, wenn die Registrierung gegen eine geringe Gebühr erfolgt und niedrige Steuern es dem Unternehmen ermöglichen, der Steuerpflicht in seinem Herkunftsland auszuweichen. Dort gehen wichtige Steuerquellen verloren, ohne dass die Unternehmen in anderer Weise zu den öffentlichen Leistungen beizutragen verpflichtet werden. Dies könnte mit dem Diebstahl von Schmuck verglichen werden, bei dem nur das Ziel verfolgt wird, ihn einzuschmelzen und den Metallwert zu erlösen.

Das Papier diskutiert die vorgeschlagene EU-Richtlinie und meldet Zweifel in Bezug auf die Möglichkeiten an, Abkommen mit niedrigbesteuernden Staaten und Territorien außerhalb der EU zu treffen. Andere Probleme bestehen beim Informationsaustauschsystem, der Definition von Zinseinkünften für Steuerzwecke sowie bei der Einführung eines gemeinsamen Steueridentifikationsnummersystems.

1 The Traditional Road to Globalization

The traditional approach to income tax, long ago, used to be a schedular system under which different types of income were subject to different tax rules. The differential treatment would affect the computation of income as well as the rates. The different rules would be explained by typical features of the different income categories. Some incomes would lend themselves to taxation at the source, some required a sophisticated computation of profits whereas others facilitated a simpler treatment, as illustrated by the difference between the accrual principle (Bilanzvergleich) and the cash principle (Überschusseinkommen).

In some cases, the differentiated tax rates took regard to the quality of the tax base. It would be in the form that the tax base was simplified to include a gross amount – then the tax rate had to be correspondingly lower. It would also take the form of assuming that some incomes, particularly those constituting business profits, invited cheating or avoidance more than others. Such considerations made it seem fair to impose tax on business profits at a higher rate than that applied to, say, wage incomes. On these, the cheating was assumed to take less substantial proportions. Moreover, if there was no separate tax on net wealth, the schedular tax on income from capital was sometimes set a bit higher than on other incomes on the theory that funded income represents more of ability to pay than unfunded income. The United Kingdom was one of the countries applying this system.

In many other countries, however, a schedular system of this kind was regarded as improper. Income as a base for taxation was meant to be an approximate measure of ability to pay. If the concept of income used for tax purposes should be relevant to the purpose of taxation according to ability to pay, it was essential to choose a concept of income serving as closely as possible as a measure of that ability. To this more modern school of thinking the schedular system did not seem adequate to serve the purpose of a tax imposed according to ability to pay. Only a global concept of income could do so.

Here, the concept of globality is used in a metaphoric way. The global concept of income includes all types of income. It is also, and here the word “global” is not metaphoric, a world-wide concept of income, in the sense that the taxpayer should be held to pay tax on all his income, be it derived from his country of residence or from abroad. Globality also includes taking regard to losses as well as to positive income elements.

The concept of taxable income is subject to other definitional problems, one of the trickiest of which is how to deal with capital gains and losses. Traditionally, income concepts have rested on definitions of income as meaning periodic receipts such as wages and salaries, interest and rent payments, and the current profits of business activities. Occasionally, some capital gains – or gains that in ordinary language have been called capital gains – have been included in the concept of income as representing the yield of a speculative activity.

Already in the 19th century, however, by David Davidson in Sweden 1889 and Georg von Schanz in Germany 1896 (followed in the US by R.M. Haig 1920 and H. Simons 1938) the argument was presented that income for the purpose of measuring ability to pay had to include capital gains in general as well as take regard to capital losses.[1] The issue was soon widened to include the problem of unrealised gains and losses. The comprehensive concept of income that von Schanz had envisaged was seen by some as presupposing realisation for gains to be taxable and losses to be deductible. Others felt that von Schanz could not be given credit for a logical and comprehensive concept of income unless his income concept was interpreted so as to include unrealised gains and losses.

This dilemma remains unsolved. The comprehensive concept of income that von Schanz as well as Haig and Simons envisaged was not only seen as less than comprehensive if unrealised gains and losses were disregarded. It raised the problem of what is realisation. What is, for instance, the difference between using the value increase of real property as collateral for a loan and selling some shares? At the same time the idea of taxing temporary wealth increases does not seem very much sounder than the purchase of oysters and champagne in celebration of a higher quotation of one's stock. The gain may be reversed whereas the oysters and champagne are gone. The implications for the tax base of its including large fluctuations in stock values are obviously serious. Experience tells that governments facing fiscal shortfalls as a result of loss deductions tend to reconsider the wide income concept causing them.

1 Davidsson, D., *Om beskattningsnormen vid inkomstskatten*, Uppsala 1889, v. Schanz, G., *Der Einkommensbegriff und die Einkommensteuergesetze*, Finanzarchiv 1896, p. 1, Haig, R.M., *The Concept of Income*, in: The Federal Income Tax, ed. R.M. Haig, New York 1921, and Simons, H., *Personal Income Taxation*, Chicago 1938.

Meanwhile, other influences have helped complicating things. One is inflation. Should inflation be taken into regard or should one rather narrow the concept of income so as to exclude those types of income on which the distorting influence of inflation was particularly strongly felt? Obviously, rampant inflation could not be ignored. If inflation was not excessive, however, the nominal principle could be defended with arguments such as a reference to the relatively better position of those who have been able to preserve the real value of their assets, if compared to those placing their money in nominal values. It remained a problem, however, that a nominal income concept allowed nominal interest payments to be deductible, although inflation helped paying off the real debt. It is a logical question whether it is fair or not to restrict deductions for interest paid with inflation referred to as the reason, if the system does not allow inflation adjustment on the positive side, say, by imposing tax on real interest only.

Another influence of the discussion has been the dispute over the "double taxation of savings". Irving Fisher has had many successors up into modern times, sharing his idea that the taxation of saved income plus the interest collected on the savings represents a double burden that distorts the taxpayer's choice between saving and consuming his income. Already John Stuart Mill had similar ideas, and after Fisher scholars such as Lord Kaldor and Sven-Olof Lodin have put up for discussion the use of personal consumption as an alternative tax base.[1] The idea of an "expenditure tax" was, on Kaldor's advice, tested in India and Sri Lanka. That happened at a time when the tax administrations in both countries obviously lacked the resources needed to make even the small minority of taxpayers affected comply with the tax. The expenditure tax was a total failure where tried. In Europe, it has gained few proselytes. In particular the international adaptation has been seen as too much of a problem. The basic issue here is that people will be tempted to earn money and build up savings in a country with a low tax on income and a high expenditure tax and spend the same money, after retirement, in another country that does not tax dissavings.

The tax legislation may be influenced by fiscal considerations. If times are bad and capital losses more common than capital gains, the legislators may be less keen on letting the government take a share in the negative results. This situation can, of course, be met with restrictions on loss deductions in combination with full taxation of gains. Most

1 Kaldor, Nicholas, *An Expenditure Tax*, Allen & Unwin, London 1955, Lodin, Sven-Olof, *Progressive Expenditure Tax – an Alternative*? Liber, Stockholm 1978.

countries, however, will find it difficult to defend such a “tails I win, heads you lose” system.

If taxpayers manage to realise their yield on capital investment in other forms than as regular income from capital, whereas the tax law allows a full deduction for interest paid and possibly emerging costs of administration of capital, the upshot can easily be that the taxation of capital is a deficit business as far as the fisc is concerned. Just as is the case with capital gains, this might be rudely remedied by stopping any deductions or credits for negative income items. Yet, a sensitive tax lawmaker unwilling to tax positive incomes while ignoring the negative ones may take the position that no tax on capital is a better idea than a tax with negative yield.

Finally, in the search for a practical income concept, tax legislators in recent years have tended to take regard to the cost to the taxpayers of compliance with and to the fisc of enforcement of the tax. In this regard, the concept of withholding at the source has been gaining ground, since it reduces the number of taxpayers the administration has to deal with directly. Moreover, in an international context withholding simplifies matters somewhat.

On another point, this approach leaves less unequivocal results. If we arrange for final withholding taxes, taxpayers may be tempted to realise their income in a form not affected by them. If, however, the withholding tax is effectively lower than the tax on other earnings, the taxpayer may be interested in showing that his income is derived from capital. A tax arbitrage between assets taxed differently will be profitable. The obvious case in point is the business firm, the profits of which can be said to represent on the one hand business profits, on the other hand yield on the capital invested. To do justice to this aspect, it might be important to establish a separation between business profits in the narrow sense and the estimated yield on the businessman’s own capital.

2 Dual Tax Systems

Against this background, there has in recent years been a tendency to return to what is de facto a schedular tax system, namely the dual income tax.[1] Based on the experience

1 For more on this see Mutén, Leif, Sørensen, Peter B., Hagen, Kåre P., and Genser, Bernd, *Towards a Dual Income Tax? Scandinavian and Austrian Experiences*, Kluwer Law International, Rotterdam, London, 1996.

of poor or even negative fiscal revenue from income from capital, and taking regard to the convenience of a final withholding system, a growing number of countries have chosen the convenient road of a dual income tax. This means that income from capital is taxed separate from other income, often named earned income. By this method, one has come to the somewhat paradoxical result that the tax on income from capital, far from including an additional element of tax on wealth, may now be lower than tax on earned income. The tax on income from capital is not necessarily lower than the tax on earned income, however. Particularly if the tax on income from capital is proportional and does not allow personal allowances, the tax on earned income may be lower for low income taxpayers.

This dual system, in turn, has implied a new approach to tax avoidance. Whereas owners of closely held companies once were tempted to take out exceedingly high salaries to get around the higher tax on dividends, the situation now is the opposite. And whereas owners of proprietary firms could let their capital work in the firm, its yield forming part of the business profits, they now have a motive for showing part of the profit as a yield on capital invested. In the opposite case, a negative yield on capital should not be allowed to reduce the business profit but should rather be treated according to the restrictive rules for losses on capital account.

The legislation in countries with dual income tax accordingly provides for a separation of income from capital and business profits. The way to establish such separation may vary. Common to all systems is complication. If the separation starts by establishing a suitable salary level for the owner, the owners, and perhaps even for their next of kin, it seems logical to apply the residual to income from capital. Yet, it can equally well be argued that applying the current interest rate, the official discount rate, or some other percentage figure to the amount of capital invested should result in a proper tax base for income tax on capital.[1] Once this has been computed, the remaining business profit should be dealt with as earned income.

It is an additional problem how to deal with the capital gain when the business is sold. That gain might be seen as exclusively being income from capital. It can be argued, however, that the same gain should be seen, wholly or partly, as the deferred compen-

1 In Sweden, where this method is applied, even a fraction of the payroll sum is added to the estimated income from capital realized by the proprietor. One is free to see this as a recognition of the *Mehrwert-theorie*“ of Karl Marx.

sation to the owner of the business for his work in the firm. In the former case the tax rate for income from capital should apply. In the latter case, the capital gain represents earned income and should fall under that tax regime.

The lower tax rate on income from capital may be defended with regard to inflation. If the nominal interest rate is 10 per cent and the rate of inflation 4 per cent, leaving a real interest rate of 6 per cent, a 30 per cent tax on the nominal interest will correspond to a 50 per cent tax on the real interest. If 50 per cent is seen as a desirable rate, then, under these assumptions, the 30 per cent rate on nominal interest is just right. But of course, if inflation is higher, or if the real interest rate is lower because the nominal rate is not much higher than the inflation rate, then the effective real tax rate may turn very high, whereas with no inflation the real tax rate will be as low as the nominal one. Therefore, it is difficult to draw any general conclusions from the inflation argument to the appropriate level of the nominal tax rate on interest. Even for that reason, it is realistic to expect that the development of tax rates on income from capital will be strongly affected by international considerations.

The interplay between taxation of income from capital and the taxation of net wealth may as we have seen take different forms. The net wealth and the income from capital may be taxed separately, or the taxation of the net wealth may be modified with respect to the income yielded by the net wealth or the taxable income from capital increased by a fraction of the net wealth. The last case is taken to the extreme by the new Dutch rule, under which the net wealth tax is abolished and a deemed income from capital computed at a standard percentage rate applied to the net wealth.

3 International Issues

3.1 Which Country Should Tax?

Internationally, the crucial issue is whether it is the source country or the country of residence that should rightly collect the tax on income of capital crossing a border. The obvious conflict of interest is between capital-importing countries and capital-exporting countries. For purely fiscal reasons, the former should be more interested in source country taxation, the latter in taxation in the country of residence. There is a clear difference here between the OECD model tax convention and the UN model; the latter

aimed at suiting the interests of less developed countries concluding treaties with industrial countries.

The issue is not a black and white one, however. A capital importing country might well come to the conclusion that a source country rule for tax on interest will in fact be a burden on its own taxpayers, the interest on their debt being fixed in terms net of tax.[1] Therefore, there are many countries, both developing and industrial ones, that abstain from tax on interest payments to foreign creditors.

It is less common that dividend payments are exempted in the source countries. They are regarded as part of the profits accrued in the source country and as such rightly subject to tax there. A similar attitude is often taken to royalties. Both the OECD model and the UN model sympathise with the former claim, only the UN model with the latter.

When it comes to capital gains, the residence country normally prevails, except for the cases of capital gains directly related to a permanent establishment. In many countries these will not fall under the general definition of capital gains but rather fit under the business profit label.[2] Another exception is capital gains on real property. These are normally referred to the situs country, and often so is also the case with shares in companies, the main assets of which are real property.

The real issue comes to the fore with respect to shares in general. Here, it is a temptation for the country where the company is domiciled to take the position that capital gains on its shares should rightly fall under the same treatment as its dividends. Traditionally, however, this attitude has not been reflected in the tax laws. The reason has mainly been administrative. The liability to tax has been limited with reference to how difficult it is for the domicile country of the company to impose an effective tax on these gains. Some countries have tried, though, and the matter is far from closed.

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1 If the foreign creditors can enjoy a tax credit for the interest at source, they may, paradoxically, be interested in a source tax being levied, provided that this tax is a burden on the debtors and not to the creditors. Brazil is a case in point, where pleas from American banks at one time caused the Brazilian government to reintroduce the withholding tax once abolished. Since a subsidy compensated the Brazilian borrowers, the IRS found fault with the arrangement, however, and refused a foreign tax credit.

2 Germany is a case in point, where gains made on *Betriebsvermögen* are in principle always taxed, whereas gains relating to property that does not enter as business assets, *Privatvermögen*, are exempt provided the holding period is long enough. Too often, it is stated that Germany has no capital gains tax, but the fact is that a considerable part of what in the US is called capital gains in Germany is taxed as business profit.

To many countries, the main issue is less one of a fair distribution of the tax base than one of ensuring that tax is at least paid somewhere. There is a horror vacui, a reaction against the prospect of double taxation being avoided at the price of no tax being levied at all. For these reasons, exemptions such as for inter-corporate dividends or for dividends paid to individual shareholders in an integrated system that makes them exempt, are offered only under condition that in some sense normal taxation has applied to the underlying profit in the source country.

Likewise, it is regarded as desirable that interest income be taxed at least once. If that does not happen in the source country, it is seen as important that the country of residence is informed about the income so as to be in a position to impose its own tax. If tax exemption is offered in the country of source, and if no assurance is given to the country of residence of the investor that its authorities will be notified about the income, this might erode the tax base of the latter country.

Here, one aspect of the modern concept of harmful tax competition comes into the picture. The residence country sees its tax base jeopardised, if savers move their accounts to countries that neither impose a tax on the yield, nor agree to exchange of information.

3.2 Harmful Tax Competition

The issue has come to the fore in recent years, although the existence of tax havens (an eschatological term comparable to the “paradis fiscaux” in French, whereas in German the perspective is closer to earth with the word “Steueroasen”) has been worrying lawmakers all since the 1930’s. There are a number of aspects to this issue that has been dealt with in recent years both by the OECD with its reporting on “harmful tax competition” and the EU that has been active both by issuing the Primarolo Report and by setting up a code of conduct.[1] Moreover, the EU has been struggling for a number of years with formulating a directive concerning the treatment of interest payments from financial institutions in member countries to persons resident in other member countries. We shall deal with this matter further down.

1 *Harmful Tax Competition: An Emerging Global Issue*, OECD, Paris, 1998; Report from the Code of Conduct Group (Business Taxation) to the ECOFIN Council on 29 November 1999 (Primarolo Report).

The definition of harmful tax competition is a matter of intense discussion. The OECD is keen on pointing out that low tax rates in themselves are not an example of harmful tax competition. What the organisation is driving at are abuses, such as "ring-fencing", when foreign investors are invited to establish their offshore activities in a country at low or zero tax rates, under the condition that no activity is directed towards the home market in the host country. Another critical point is transparency, and a related issue, the absence of information or any co-operation between the host country and the investor's country of domicile.

The main attack against this concept has been led by those, who maintain that lower taxes are always better taxes.[1] Critics talk about a "high tax cartel" and feel that the concept "harmful tax competition" stands for protecting the high tax rates in OECD countries, whereas in their opinion lower taxes are a prescription for faster economic growth.

No doubt, taxes may well be too high in some countries, and excessive taxation has certainly retarded economic growth, particularly in times when tax rates were higher than they are now. Still, it is obviously necessary to query whether the experience that tax reduction from an extremely high level promotes growth must necessarily imply that reducing taxes to zero is still a growth-promoting policy. Most people would agree that the ideal lies somewhere in between, at a level where the tax rates are not extreme, yet high enough to allow the financing of a reasonably extended public sector, one that offers security under the law, social security, including satisfactory health care as well as reasonable pensions, and a functioning school system. If we apply Rawls' criterion, under which that kind of state is preferable in which we would choose to live, if we had to make the choice not knowing whether we would be rich or poor, the state with extremely low taxes would get few votes indeed.

It is also only natural that citizens of a functioning social state look askance at those, who enjoy the benefit of health care for children, free schools and other benefits, and then get out of the country to make money, coming back in their old days to benefit from the home country's extended care for the old. Many of us feel reluctant to put a stop to this by way of a "Reichsfluchtsteuer" or by applying the Soviet model of charg-

1 For an extensive account of these critical points of view, see Mitchell, Daniel J., *An OECD Proposal to Eliminate Tax Competition Would Mean Higher Taxes and Less Privacy*, Tax Notes International 16 October 2000, pp. 1799-1821.

ing emigrants with the costs for health care and education incurred for them by the state. We must also reject Jagwad Bhagwati's proposal against brain drain, charging an additional tax in the host countries for remittal to the countries of origin of the immigrants.[1] Expatriation taxes are charged to emigrants in countries like Canada to ensure that capital gains taxes cannot be avoided by emigration, but even a limited measure like this requires complicated rules as well as extremely difficult co-ordination with the tax system in the new country of residence. Some capital gains tax systems, as was noted above, extend to emigrants during the first years after emigration. And finally, we can study the US efforts first of all to tax citizens wherever they are resident, and second to go after them if they give up their US citizenship. The former rule has been a failure in countries imitating it and less than a thundering success for the US itself. If it has worked at all, it is mainly a product of what must be called extraterritorial exercise of administrative power, something that other countries might have great trouble to get away with. *Quod licet Iovi, non licet bovi.* (What Jove might allow himself is not allowed to the ox.)

Against this background, it is easy to understand why the argument that tax competition is always useful meets with strong resistance. The prospect that tax competition may lead to a "race to the bottom" may be a hope for some but is genuinely felt as a source of fear by those who believe that the state, and the public sector in general, has an important role to play for the wellbeing of society.

Harmful tax competition is clearest defined with respect to offshore activities. Soliciting foreign investment to promote the host country's economic development may constitute tax competition and may, indeed, sometimes imply that employment and economic growth is promoted in the host country at the expense of employment in the investor's home country. Yet, promotion measures of this kind have been given a friendly reception in most countries, even though a certain fatigue has been noticeable in recent years. Until recently, most countries, with the important exception of the US, were ready to accept and support the incentives offered by developing countries. If the tax treaties with these countries did not provide for a territoriality rule, the effectiveness of the tax incentives was normally ensured by tax sparing clauses.

1 Apart from the complication, just think about the feelings of immigrants from inhuman dictatorships, if their tax money were used to feed the dictators they had fled from!

The international opinion has changed somewhat in this respect. First of all, it is noted that some countries offering incentives to foreign investors have grown to a point where they are not more seen as in need of support. It is seen as superfluous to offer tax sparing to countries like Korea and Singapore. Second, the negative attitude to tax sparing that once was characteristic for the US and not many more states has affected the thinking in the OECD.[1] Third, the incentives of some countries have been directed towards offshore activities of doubtful value to the real economic development of the countries offering them, but rather falling in the category of harmful tax competition. The tendency is to be more selective when offering the benefit of a tax-sparing clause.

The main direction of the international action against harmful tax competition concerns these offshore activities. If states are in a position to attract foreign investors, not for the purpose of developing the economy of the host country, but for the purpose of offering a tax base broad enough to give a meaningful contribution to the host country's treasury even at a tax rate close to zero it is felt that the system is in jeopardy.

The globalised economy may imply that real business activities are moved from one country to another. This is in the spirit of free trade and means that relative production advantages are taken care of.

The attraction of tax bases such as holding companies is obviously a different matter. If a tax haven country attracts that type of companies, the purpose is not one of developing its own economy and making use of its productive resources, but just to gain access to a tax base broad enough to be profitable at a minimum tax rate. The situation seen in the perspective of the countries losing the migrating tax base may be likened to the case of thieves stealing precious jewellery only to melt it down and cash in the metal value. In the new host country, the potential value of the offshore companies as a tax base is not realised – if it were, the companies would not dream of establishing themselves there. In the country where the companies have their original base, the loss of them as part of the tax base is much greater than any gain flowing to the new host country.

Of course, this perspective is not that of the investors. To them, the situation is rather that the company has chosen its tax jurisdiction on the basis of the interest of itself and its shareholders, finding the low-tax country more attractive than the high-tax country.

1 OECD: *Tax Sparing: A Reconsideration*, Paris 1998.

There is no unanimity with respect to the question of the moral right of the original country of domicile to the tax base represented by the company.[1] In a globalised economy, it is not always easy to establish whether a moral right to tax is enforceable or even morally recognisable. If a company has shareholders in many countries and activities in many countries, its commitment to its country of domicile may sooner or later turn into a question of profitability rather than to one of patriotism.

If we want an objective answer to the question whether tax competition is harmful, we are in for a delicate problem. We must establish who is hurt and who is benefiting. We must likewise establish whether or not the harm to one party is outweighed by the benefit to the other party or to the world in general. And finally we have to establish the relative dignity of competing interests.

With respect to tax competition forcing down the tax rates in general, we might take a positive attitude to this effect in cases where the tax rates are excessive. A race to the bottom, on the other hand, cannot be useful, and if states imposing normal taxes are losing tax bases as a result of tax competition, it is legitimate to regard this effect as harmful.

The benefit of the race goes in the first hand to the prospective taxpayers who get off with much lower tax than they would have had to pay but for the competitive tax measures. Again, we have to take regard to the alternative of staying home and declaring the income there. If the home country tax is excessive, the relative advantage of the low tax regime in a state engaging in tax competition might be significant. On the other hand, a broader perspective on the situation of the investor might well imply some reflection on the public service standard, the infrastructure, the general stability etc. that may influence an investor's choice of location. Freedom from tax may well be combined with an obligation of foreign investors to accept financial burdens that normally lie on the shoulders of the country's treasury.

The gain is more unequivocally on the side of the investor in those cases where the investor has no real connection with the tax haven state. In that case, the investor might

1 It was an illustration of this when the spokesman of a major US company, heard by a senate committee last year, said that his company, if once again given the choice of domicile, would have selected Cayman Islands. A number of senators and others let it be known that they regarded this statement as unacceptably unpatriotic.

well regard it as outside his sphere of interest whether the social service and the infrastructure in the host country are up to standards or not.

It is at this point that we come to the weighing of relative advantages and disadvantages of the home country and the host country. We mentioned the example of the art thief. A tax haven country that grossly underutilises the taxpaying potential of companies it has attracted by tax haven conditions may benefit from the registration fees or minuscule taxes paid by the offshore companies, but not in proportion to the loss incurred by their normal-tax home countries.

Again, weighing benefits and losses, we have to be alert to the fact that the question of corporate domicile is anything but straightforward. We may stick to the rights of the country of registration, but aren't we also ready to take note of the beneficial ownership of the shares? Or we may establish corporate domicile in the country of actual management, only to stumble over the fact that the managers may move to an obscure tax haven to make the big decisions. Countries with normal tax systems may find a solution to this problem through tax treaties or through discussions between the competent authorities. Tax havens normally abstain from concluding tax treaties and their authorities are rarely ready to make deals with authorities in countries with normal taxes.

Before the Subpart F legislation entered the IRC in 1962, many of us were doctrinaire on this count, rejecting the measure as implying extra-territorial taxation, a violation of the host country's sovereignty. This attitude is not quite as easy to maintain after a great number of countries in turn have adopted similar CFC legislation. Note also that a growing number of states have established limitation on benefits clauses in their tax treaties with the purpose of avoiding treaty shopping, but with the obvious implication that the domicile of a company may not tell the full truth about where its profits should primarily be taxed. This approach may also lead us to the conclusion that a company may be seen as an instrument of its beneficial owners, which in turn gives the state where they or a majority of them are domiciled a legitimate interest in the tax treatment of the company.

If this line of thinking cannot be effectively pursued in forming the international tax system, we must face the alternative of company profits gradually leaking out of the systems of normal tax countries into a universe of tax havens. It is unlikely that citizens around the world, paying by their taxes for what they regard as necessary functions of

civilised states, will accept as competitors, suppliers, and employers anonymous, homeless, and unaccountable international enterprises with addresses in states refusing co-operation. Or are the flags of convenience in shipping just a foreboding of what is to come with respect to business in general?

3.3 The Proposed EU Interest Directive

Slowly, the ministers of finance of the EU countries have worked out a compromise with respect to the proposed directive for the treatment of interest payments by EU countries. This is only one aspect of the tax competition issue, but already this issue has proven to be extremely difficult to solve, and even after the compromise dated November 27, 2000, it is fair to ask whether what is now on the table is a solution or the opening of a Pandora's box of new problems.

Basically, the question is how we can combine the common wish for a general income tax, including tax on interest income, with the two countervailing tendencies, one, the principle of bank secrecy, the other, the idea that interest payments to foreign lenders or depositors should be left tax exempt with a view to avoid shifting of the tax burden to the domestic borrower.

The wish for a general income tax is common. In the German case it has been emphasised by the pronouncement of the Constitutional Court that the income tax would be unconstitutionally unfair if not extended to interest income. In this situation, lawmakers have seen a remedy in withholding taxes. These are particularly needed in those countries where bank secrecy is observed and prevents regular information returns from being issued by the banks to the tax authorities. Experience has shown, however, that the public may well react on withholding taxes by moving their accounts to foreign banks, located in countries where neither withholding tax, nor information to the domestic tax authorities, prevents the foreign investor from enjoying his interest yield without tax.

The first German effort to introduce a withholding tax on interest met with such a general exodus of savings to Luxembourg that the tax had to be repealed. A new tax was required by the constitutional court but is provided with a basic allowance large enough to make the tax ineffective against most savers. In other countries, withholding taxes are often more general.

At any rate, the introduction of a withholding tax at home still has the effect of making savers look for better conditions elsewhere. Of course, the law may prescribe that tax must be paid on all interest payments received, be they domestic or foreign. Without a functioning information system, such legal bidding will have little result. A country like Sweden may prescribe registration of all foreign bank accounts with the tax authorities and, to boot, an obligation of the registrant to present to the Swedish tax authority a commitment of the foreign bank to provide the Swedish authorities with all the particulars Swedish banks are supposed to provide them with. Apart from the fact that some foreign banks would violate their countries' bank secrecy acts if complying, the eagerness of Swedish taxpayers to make them comply and to register their bank accounts is very limited indeed. Only few Swedes have registered, and the legislation is for all practical reasons a flop.

Therefore, it is important to countries wishing to have an effective and general income tax to come around the problem of other countries opening opportunities to tax exempt or easily hidden interest income. Here is the reason for the European effort to achieve a general tax on capital, payable in all EU countries, and at best in all other countries as well. Alternatively, an information system is sought that would make a world-wide taxation of interest possible for countries interested in applying such a tax.

The first hurdle to take was the United Kingdom with its Eurobond market. The problem here was, specifically, that the Eurobonds are issued at a guaranteed interest rate after withholding tax. If such a tax is imposed, it is for the borrower to pay. If the borrower is hit by a withholding tax, however, the conditions for the normal Eurobond allow the borrower to renegotiate the loan. Given the historically high interest rates at which many Eurobonds were issued, and the rather low present rates, the borrowers would gain by this condition being applied. Correspondingly, the present value of most Eurobonds would drop considerably, if the renegotiations clause were applicable. Hence the stubborn opposition of the United Kingdom to a directive prescribing a withholding tax.

At the same time, the U.K. has shown some flexibility with respect to the alternative approach to the problem, the information system. This system, however, does not square well with the bank secrecy rules in countries such as Luxembourg and Austria. In Austria, the authorities have been remarkably successful in regaining Austrian savers by offering them a tax amnesty and the opportunity to open anonymous accounts. To the

Austrians, a low withholding tax would seem much more palpable than any information system.

On the side of Luxembourg, some understanding for a general withholding tax has been noted, but with the condition that something be done against the foreign competition. Luxembourg has not seen the value in a common European move that would have as its only result that savers, who once fled to Luxembourg, will now leave Luxembourg for the tax havens in the English Channel, for Switzerland and Liechtenstein, or for some tax haven in the Caribbean. Luxembourg might have a reputation for tax sheltering inside Europe, but it would find it a symbolic action for little purpose, if its financial system were subjected to drastic change only to see the funds now taken care of in Luxembourg dispersed into other countries, outside the EU.

Therefore, it is a condition for the application of the proposed directive that Europe comes to terms with a number of important tax havens. The reason is obvious, and the resources, particularly if the EU and the US work together, might be seen as awesome and might well bring around at least a good many of the countries involved. (The OECD home page, incidentally, brings optimistic bulletins about the combined success of the efforts by OECD, EU, FATF, set up by the group of seven, and other groups.) The difference is great, however, between an official proclamation of willingness to co-operate and the actual pursuit of each and every foreign investor coming in to enjoy the good financial climate of a tax haven.

As far as Sweden is concerned, with its 30 per cent tax rate on all income from capital, the country will not be likely to attract many investors if it maintains its withholding tax at that level and extends the tax to the now exempt non-residents. To preserve its revenue, the country must favour an information system.

3.4 Weak Points of the Proposed Directive

Critics have been quick to note that the November 27, 2000, agreement as well as its predecessor made in Feira, Portugal, in June 2000 must be seen as incomplete. The information system was seen as the best alternative in the provisional agreement achieved at the Feira meeting. Conditions concerning the collaboration of tax haven countries outside the EU made this agreement a mainly theoretical exercise.

The new agreement offers a combination of withholding and information. Austria, Belgium, Luxembourg, and perhaps Greece and Portugal can apply a withholding tax under the agreement, 15 per cent during the first three years, 2003-2006, and 20 per cent in 2007 through 2010, after which year an information exchange system would take over. The countries using the alternative of a withholding tax would transfer 75 per cent of the receipts to the investor's country of residence and retain the rest.[1] The new directive will under the Nice agreement still require unanimous consent. Optimistically, it is predicted that this will be achieved some time during 2002.

In the new agreement, the agreed rate is lower than many countries now apply. The revenue interest of the home countries is not fully satisfied with the 75 per cent share promised. This is even less so, given the expected practical problems meeting the identification of depositors and the establishment of their country of residence for tax purposes.

It has also been noted that the proposed directive is supposed to cover interest only. Dividends and the yield of investment funds are not included; yet, it is believed that a majority of those trying international tax evasion invest mainly in shares.

What is perhaps as fatal, the concept of interest is seemingly not defined in the agreement. Zero-coupon bonds may in some countries be regarded as offering an interest yield realised at redemption. In other countries the same amount is treated as a capital gain. Even more difficult is the treatment of compensation for accrued interest received by the seller of a financial instrument. Moreover, the really great complication is the treatment of gains on the disposal of zero-coupon bonds before redemption. Here, the gain realised by the seller cannot be seen entirely as accrued interest, since the value of the bond may also have been influenced by shifts in the market interest rate and changes in the solidity of the debtor. How could a distinction be made between one element and the other, when all that is accounted for, if any accounting takes place, is the difference between the emission price and the price paid at the disposal of the financial instrument?

A further complication, on which nothing has been said in the press releases, is the practical application of an information system. Even with names and addresses in per-

1 For a summary of the agreement, see Joann M. Weiner, *ECOFIN Makes Significant Progress in Adopting Savings Tax Package*, Tax Notes International, 4 December 2000 p. 2547-50.

fect order, a TIN (taxpayer identification number) is a necessary condition for making a general information system work. The Swedish banks have made it clear early on that their computers as presently programmed would reject foreign TINs. Issuing Swedish TINs to foreign savers would not be helpful. Just providing information by name and address would cause the tax authorities more work than the matter is worth.

To add insult to injury, the forms of names differ between countries. A Swedish married woman normally (but not always) carries her husband's name, but in Belgium, if she moves there, she will be on the tax rolls under her maiden name only. In Spain, the middle name will often be regarded as the first part of the family name, and such a simple mistake makes it close to impossible to identify the person on whom information is offered.

In this context, some lessons might be drawn from the US experience of "qualified intermediaries", in other words foreign banks authorised to screen investors in US securities, establishing who belongs under the US tax net and who does not.[1] The complication of that operation gives a hint of what the European countries might be in for, if they want a watertight solution to the problem of ensuring a complete tax coverage of all income from capital realised by their residents.

The new agreement retains the conditions, insisted on particularly by Luxembourg, concerning co-operation of non-EU countries such as Andorra, Liechtenstein, Switzerland and the United States as well as of dependent but not participating territories such as the Channel Islands and the Netherlands Antilles. Already on the day after the agreement Switzerland reaffirmed its refusal to make its banking system more transparent.[2]

In other words, we have a long way to go. Some will find the road so difficult and the problems we shall meet along the road so horrifying that they will opt for no tax at all on income from capital. Others, like this writer, may find the generality of the tax and the principle of taxation according to ability to pay as important as to be worth a good deal of political and administrative effort. What we will not be well served by, however,

1 Cf. T.D. (Treasury Decision) 8734, issued in 1997 and containing regulations to a considerable number of sections of the Internal Revenue Code, notably Sec. 1441. Note that this bulky document of around 400 pages just sets out the principles of ensuring the US tax claim. It has been followed by detailed agreements taking regard to the mode of operation of the bank system in each particular country.

2 *Switzerland Impedes EU Savings Plan*, Tax Notes International, 11 December 2000 p. 2668.

will be a system that may be a trap for the unwary but will leave the big evaders free to go on as before.