TAXATION OF INTEREST INCOME IN EUROPEAN UNION COUNTRIES

Ing. Peter Oravec

For several years now EU countries have been seeking to harmonise national rules on taxation. One area of harmonisation is also that of the efforts towards the integrated taxation of income flowing from sources within the respective state (interest income) by means of a control report to the financial authorities or by way of a unified withholding tax. The idea of harmonisation is to prevent the illegal evasion of taxation of interest income.

In the taxation of interest income four principal approaches may be identified:

a) Prepayment: Tax from sources of interest income (tax from income flowing from sources within the respective state) is collected as an advance deposit, or prepayment, for the income tax. Subsequently each depositor must state interest income in their tax return. In determining income tax, taxes already paid (withheld) from the source are included in the calculation of the overall tax liability.

b) Withholding tax: Tax from the source is withheld as a tax collected by deduction (final, final tax); interest income is subsequently not included in the tax return and thus neither in the calculation of income tax. This tax may be connected with the possibility of an additional calculation of the tax.

c) In the framework of taxation of income: tax on interest income is calculated in the framework of taxation of income; interest income is registered by means of the system of control reporting (for ensuring the complete taxation the necessary data is declared to the financial authorities).

d) Unadjusted: this is a so-called "net" regulation of tax, i.e. there is no tax at source, nor is a system of control reporting implemented. This however does not have to necessarily mean that interest income is not subject to tax; it can however mean that it continues to be subject to income tax.

In taxing interest income flowing from sources abroad (cross-border interest income) it is necessary to differentiate between:

a) interest income of domestic citizens abroad (interest income of domestic citizens flowing from sources abroad),

b) interest income of foreigners living in the given country (interest income of foreigners flowing from domestic sources).

Taxation of interest income in EU countries

As results from the overview stated in appendix 1, at present withholding tax is used in seven of the fifteen EU member states. In these countries (Belgium, Finland, Greece, Portugal, Austria, Italy, Great Britain) the tax duty is settled through withholding tax as a final tax. This in particular concerns those countries in which the obligation of adhering to bank secrecy is in a more or less strict form.

In certain countries (France, Ireland, Germany, Spain) is used a prepayment system of tax withheld against the tax return. In Belgium, Finland, France and Portugal a taxpayer may choose between withholding tax return on the one hand, or prepayments against the tax return on the other.

In four EU countries (Denmark, Holland, Sweden, Luxembourg) tax is not withheld or prepayments collected, while in the first three countries interest income is included in the tax return, while in Denmark, Holland and Sweden, there operates an extensive system of submitting control messages thanks to which the tax authorities have sufficient information for enforcing their claims in the field of tax returns.

Highly liberal regulation operates in the field of taxation of income in Luxembourg, which together with certain associated areas of EU member states does not apply any taxation, where here with regard to the strict banking secrecy applied there does not exist any system of submitting control reports; this system is termed "net" tax regulation.

Interest income of domestic citizens from sources abroad may be included in the tax liability on the basis of the principle of the domestic state, where by rule a prepayment system operates with the tax paid abroad (on the basis of respective agreements on limitation of double taxation). With regard to the non-existence of an institutionalised regular notification, or agreement on the amount of interest income between member state, taxation of this interest income flowing from sources abroad depends as a rule simply on the correctness and completeness of the taxpayer's tax return.

Interest income of foreigners from sources in a given domestic country may in the domestic country be subject to withholding tax, or such income may be free of taxation. In EU member countries it may be said that there are different taxation systems for deposits of domestic citizens and foreign citizens, where in certain countries no tax applies in respect of deposits of foreign citizens (foreign depositors). This situation leads to the fact that EU member countries are for depositors from other member countries in certain cases becoming a tax haven.

Of the EU countries Germany in particular suffers from capital flight caused in this manner. The country therefore has a great interest to attract back these deposits of its taxpayers. German taxpayers avoid the system of prepayment applicable in Germany (prepayment of tax withheld and subsequent taxation in the framework of their tax return), depositing the money in other countries, for example in Luxembourg and do not include these interest income in their tax return, whereby they do not pay withholding tax collected by deductions and their own interest income is not taxed either by income tax. Overall this capital flight is estimated at up to 400 billion euro, other estimates speak of an annual outflow of taxes on interest in Germany in the amount of at minimum 7 billion euro. Less known however is the fact that for residents of Luxembourg it is better to deposit their money in German banks.

The elimination of reasons for making interest income secret in respect of domestic financial authorities is not only in the interest of the correct debiting of taxes, but is also a condition for the efficient allocation of capital on the basis of economic criteria. Keeping interest income secret is moreover unacceptable at a time when member states are striving to strengthen budgetary discipline and distribute taxes equally on the various factors of production also in the interest of gaining and maintaining jobs.

Draft directive of the Council for ensuring the minimum efficient taxation of income from deposits in the form of interest payments (interest income) in the Community (1998)

Preparation of the draft directive

Back in 1967 the European Commission expressed itself in favour of a unified 10% tax at source. The Council directive on liberalisation of the capital market (88/361/EEC) of 1988 was an impulse for the EU Commission towards submitting a proposal for the removal or minimisation of the risk of tax liability avoidance in consequence of the differences in national rules on taxation of interest income. On 10. 2. 1989 the Commission submitted the first draft directive, which contained three mutually non-exclusive alternative arrangements: implementation of a unified withholding tax, implementation of a system of automatic control reporting and expansion of the system of notification between tax authorities. This proposal foundered in 1989 in consequence of the non-consent of certain member states (Luxembourg's veto).

The lack of uniformity in the taxation of interest income in the EU has led to the fact that in the mid-1990s the USA and Switzerland broke off their negotiations with the EU on the taxation of interest income with reference to the fact that the EU must at first itself adopt binding norms applicable in its own territory. Until there exists agreement and concord at the level of the EU, international agreement, for example at the OECD level, appears impossible in this field. On the basis of principles agreed by finance ministries of the EU at the meeting of 1. 12. 1997 the Commission submitted in May 1998 a new draft directive of the Council. The aim of this draft is to ensure a minimum efficient taxation of interest income paid in one member state by a natural person with permanent residence (address) in a different member state. This proposal was based on a compromise between one group of member states, which insisted on adhering to banking secrecy and therefore requested implementation of withholding tax on domestic interest income and interest income from sources abroad through a unified minimum tax rate for all EU countries, and a second group, represented in particular by Great Britain, which sharply rejected this approach and proposed a system of exchange control reporting.

Principles of the draft directive

The draft directive concerns only taxation of interests income received in the EU by natural persons having residence in a different member state than that in which interest income are paid and does not concern citizens of third countries. The draft directive requires minimum taxation of cross-border interest income. Besides this, there is proposed with regard to the efficient use of taxation a flexible model of the two systems' co-existence, between which each member state must choose:

a) implementation of withholding tax for foreign citizens: calculation of direct tax withheld by deduction at source in the amount of at minimum 20% of the interest income (a member state can decide on the use of a higher rate); or

b) the provision (exchange) of information to the respective authorities of other (domestic) member states on interest paid to natural persons with residence in these countries (information is provided automatically and is not subject to limitations or conditions). The information should contain the amount and periods of interest payments, as well as a notification of the recipient of the interest income.

The most important factors in the market for the effective enforcement of this directive are the payment sites, i.e. banks or any other market participants that pay interest. These must either provide the required information or deduct tax at source. According to the proposal member states should adopt the necessary measures in order that banks registered in their territory may correctly perform the required tasks.

A natural person may decide that the interest income from savings deposited in a different member state that has opted for a system of withholding tax is taxed exclusively in the country of residence. In this case this natural person must ask the tax authorities of their domestic country for a confirmation, which authorises the bank in which the person has their savings deposited, to not deduct tax at source. For the prevention of any double taxation the country in which the natural person has their residence must include the tax paid in its calculation, if the interest income has been taxed by deduction at source in a different member state.

Member states with dependent or associated territories must require these to implement the same measures. Similar efforts need also be made in respect of third countries; each member state should adopt the respective measures in relation to these countries. The proposal requires that the EU begins, following adoption of the directive, negotiations with economically important third countries in order that payment sites located in these countries use the stated principles in respect of interest income paid to taxpayers with residence in EU member states.

The progress and results of negotiations on the proposal

The Commission submitted its draft directive on 20.5.1998. The European Parliament on 10.12.1999 submitted ten comments in respect of the proposal; in the opinion of the European Parliament the measures of the directive should not limit fair tax competition between member states and other sensible relaxation of tax pressure. In the comments of the Parliament there is highlighted the significance of agreements between countries that provide foreign citizens especially tax advantageous conditions (tax havens).

In 1999 to 2001 the Council in connection with this directive conducted intensive discussions at the political as well as professional level. The proposals of the Commission encountered at first a negative standpoint from Great Britain, which however under certain conditions in the end agreed with the provision of information on interest income paid to foreigners. The main opponent of the directive thus again became Luxembourg. In the framework of professional consultations in particular from the side of Great Britain it was stated that both proposed options in the framework of the co-existence model cannot be considered alternatives, as their use leads to essentially different consequences. Tax withheld at source raises tax revenues of the state in which the funds are deposited (the country importing capital), while in a system of control reports there occurs an increase in the tax revenues of the state in which the depositors have their residence (the state exporting capital). Withholding tax in a state importing capital requires the inclusion of the tax in the framework of the tax return in the state exporting capital. Countries that were to decide in favour of withholding tax and thereby debit the tax from the interest income of foreign citizens, however, according to this proposal would no longer be subject to the system of control reports. At the same time these countries are also advantaged by the fact that they gain from other EU member states information on the interest income of their citizens and tax these fully. This further leads to the fact that if the rate of a withholding tax were lower than the tax rate in the framework of the tax return, taxpayers would simply try to pay withholding tax as the final and definitive tax and would avoid the further inclusion of this interest income in the tax return in the country in which they have their residence. This would lead countries trying to attract capital towards a minimisation of the rate of withholding tax towards a further deformation of tax competition. On the other hand countries giving preference to the system of control reports would be disadvantaged and this pressure would lead them to a change in the direction from the reporting system to implementation of tax at source.

Draft directive of the Council for ensuring efficient taxation of income from deposits in the form of interest payments (interest income) in the Community (2001)

Preparation of the draft directive

In the course of negotiations over the preceding draft directive the Council changed its opinion substantially. The possibility to opt between withholding tax and the exchange of information was replaced by a proposal aimed only at the second system, i.e. the system of the exchange of information, which requires payment of tax on interest income in the country of residence of a natural person. This proposal however came up against the problem of the protection of banking secrecy, which is adhered to very strictly in many EU countries, Luxembourg, Germany and Austria among others. Great Britain insisted on the fact that, in the case of providing information by one country to other countries, reciprocity must be ensured, i.e. that the exchange of information must always be mutual. As a compromise therefore Great Britain submitted a proposal for the co-existence of both systems over a four-year transitional period. Luxembourg, Belgium and Austria however sharply rejected the cancellation of direct withholding taxes with reference to the protection of banking secrecy. This argument however is doubtful for the reason that the control system should provide information only on interest income and not on movements or account balances.

Following the meeting of the European Council in Santa Maria de Feira on 19. and 20. 6. 2000 and the Council of finance ministers of the EU on 26. – 27. 11. 2000 the Commission submitted a new draft directive, which differs substantially from the previous proposal. The EU inclined at negotiations at Feira principally towards the British standpoint, the ministers of finance of the EU member states in Feira reached accord on the fact that following a seven-year transitional period for Belgium, Luxembourg and Austria a system of control reports must be replaced withholding tax. This decision concerns also dependent and associated territories of Great Britain and Holland, among others Jersey, Guernsey, the Isle of Man, Gibraltar, Madeira, British Virgin Islands. Third countries, (specifically the USA, Switzerland, Liechtenstein, Monaco, Andorra and San Marino) will be asked by the EU to adopt similar measures. Following sufficient assurances from the side of the third countries and dependent territories, however at latest by the end of 2002 the Council should have a definitive decision on this directive.

Principles of the draft decision

The proposal covers all types of interest income, also from loans, where for existing loans a transitional regulation is expected. The directive concerns income from cross-border capital deposits, which are paid in the form of interest payments in one member state to natural persons with their place of residence in a different member state. This does not affect for example interest income paid to domestic citizens in a specific member state or interest income of persons with their place of residence in a third country. A member state, in which a taxpayer has residence, may decide whether or not it will tax the interest income. With regard to the fact that in the taxation of natural persons there arises a substantially higher risk of taxes being made secret than that in the field of taxation of enterprises, which must each year submit a tax return and their accounting is subject to control, the proposal does not relate either to interest payments paid to enterprises.

The original proposal of 1998 put the choice between the exchange of information and withholding tax in the hands of member-states. The essential difference between this and the previous proposal thus lies in the fact that from member states there is expected the exchange of information on interest paid to foreign citizens; this proposal corresponds to the international trend towards growing co-operation and intensification in the exchange of information between states. In future all member states will be obliged to provide other member states information on interest paid in a certain member state to natural persons with residence in a different member state. During the seven-year transitional period Belgium, Luxembourg and Austria are obliged either to provide the respective information, or they can instead of this during the first three years of this transitional period apply withholding tax in the amount of 15% and during the remaining four years in the amount of 20%. These three member states will retain 25% of revenues from the withholding tax and the remaining 75% will be transferred to the member state in which the depositor has their residence. Following the elapsing of the seven-year transitional period all member states must institute a system of unlimited information exchange.

It is necessary to state that an exchange of information on interest income already occurs in a certain limited extent (see Appendix 1). Legal regulations exist which require the exchange of information between EU member states, for example bilateral agreements on the limitation of double taxation contain clauses on the exchange of information and also Directive 77/799/EEC on the mutual official assistance in the tax field requires the exchange of information. It however remains problematic the fact that in these cases member states do not have to provide information, if this were to conflict with domestic legal regulations or correct practice, or if the state which requires the information is not able to provide such information on a reciprocal basis. Through the adoption of the proposed directive there shall be instituted a system of the exchange of information between member states in the field of taxation of interest income.

As in the preceding proposal also the new proposal is based on co-operation with market participants directly making interest payments. The payment sites, as a rule a bank, which makes interest payments to a natural person must either provide information to the member state in which the recipient of the interest payments has their place of residence, or during the transitional period to apply withholding tax and transfer it to the respective member state. Interest income is in this case taken to mean interest payments that are to be paid to a natural person with their place of residence in a different member state regardless of whether these interest payments arise within the framework or outside the EU. The proposal requires that the payment sites must state who is the economic owner of the interest payments and where they have their place of residence. In the framework of the proposal all efforts however have been made to limit the administrative burden on payment sites and to minimise the expenses arising. In the case of contractual relations concluded prior to the directive's adoption, a payment site must ascertain simply the name and address of the economic owner of the interests income, and this on the basis of existing information (financial institutions must already, pursuant to the valid Directive 91/308/EEC on the Prevention of use of the financial system for money laundering purposes, ascertain the identity and place of residence of their regular clients). In the case of contractual relations arising following the directive’s adoption the payment sites will also have the commensurate obligations, for example to ascertain the tax identification number of the recipient of the interest payments. On the basis of this information payment sites will have to deduct and transfer tax at source or provide to the member state in which the recipient of the interest payments has their residence, information on their interest income.

Adoption of this proposal requires adherence to general conditions and requirements for negotiations with dependent and associated territories of Great Britain and Holland and third countries (USA, Switzerland, Liechtenstein, Monaco, Andorra, San Marino).

Progress and results of negotiations on the proposal

On 18. 7. 2001 the Commission submitted a new draft directive. The legal basis of the proposal is formed by article 94 of the Treaty, according to which the proposed Directive must be unanimously adopted following a hearing in the European Parliament and in the Economic and Social Committee of the Council of Ministers. The proposal was submitted to the Council; in parallel with negotiations in the Council, the Council Board and the Commission are leading joint discussions with third countries in the interest of equal measures being adopted in these countries. Member states are concurrently working to implement equal regulation in dependent and associated territories.

Taxation of interest income has also been the subject of other meetings of committees of the economy and finance ministers of EU member states. At the meeting of the committee on 4. – 5. 3. 2002 in Brussels a standard scheme was agreed, which the member countries will use for the mutual exchange of information. According to the proposed directive, the provision of information with the use of this standard scheme will be performed automatically at least once a year. At the meeting of the committee on 3. 4. 2002 in Luxembourg it was stated that progress had been achieved with countries apart from Switzerland, which made the opening of negotiations in this matter conditional upon an EU mandate to negotiate also on a range of other issues. The first negotiations with Switzerland at the level of experts were held in Bern on 18. June.

Switzerland's opinion on taxation of interest income in the EU

Switzerland has for long time applied a system of withholding tax, which together with the system of income taxation ensures the efficient taxation of capital incomes and at the same time suitably protects banking secrecy of natural persons. It is not however in Switzerland's interest to attract deposits aimed at avoiding the respective EU directives; if therefore the EU definitively agrees on the specific wording of the Directive, Switzerland will be prepared under the condition of compliance with banking secrecy to seek a way so that the avoidance of EU regulations would not be attractive for natural persons with their residence in the EU. In either case however the system of automatic control reports is unacceptable for Switzerland.

A possible arrangement could be based on tax at source through the application of so-called "payment site tax" from interest income of foreign depositors. This would mean the implementation of a system of withholding tax on interest income from foreign deposits paid to natural persons taxed in an EU member state. This tax would from the point of view of Switzerland not require any constitutional changes, because this would not actually be the introduction of a Swiss tax, but rather an instrument for ensuring EU tax rules in Switzerland on a treaty basis. At negotiations with the EU on 18 June 2002 Switzerland again refused the model of the automatic exchange of information and put forward the withholding tax as an equal measure.

Taxation of interest income in countries outside the EU

For comparison there is shown in Appendix 2 also an overview of the taxation of interest income in countries with transforming economies. As is apparent from the appendix interest income in Estonia, Croatia, Lithuania, Latvia, Macedonia and Slovenia are not subject to tax in the framework of income tax and nor in these countries is withholding tax applied. In Albania, the Czech Republic, Georgia, Poland and in the Slovak Republic withholding tax on interest income is applied, where the tax rate moves between 10% and 20%. An exception is the Ukraine, where income from interest payments is included in the tax return.

Literature:

1. Brabínek Aleš. Dohoda o zdaňování vkladů v EU opět v nedohlednu, in: Europe's, 6. 6. 2000.
2. Commission adopts new proposal on taxation of cross-border sa-vings income. 18. 7. 2001, http://europa.eu.int/comm/taxation.
3. Hartel Hans-Hagen. EU-Zinsbesteuerung weiterhin ungeklärt, in: Wirtschaftsdienst, 07/2001.
4. Huizinga, H. – Nicodème, Gaëtan, Are international deposits tax-driven?, Economic paper, June 2001, http://europa.eu.int/econo-my'finance.
5. Mutén, Leif, Taxation of Interest in the European Union, in: Intereconomics, January/February 2001.
6. Nuessgens, Heinz – Josef, Reform der Zinsbesteuerung: Kontrollmittclungen oder Abgeltungssteuer?, in: Die Bank 5/2000.
7. Rozdielne zdaňovanie v krajinách EÚ, in: Národná obroda, 4. 1. 2000.
8. Savings Tax Proposal: frequently asked questions, 18. 7. 2001, http://europa.eu.int/comm/taxation.
9. Schratzenstaller, Margit-Wehner, Holger, Zinsbesteuerung in der Europäischen Union, in: Wirtschaftsdienst 11/2000.
10. Snahy o jednotné zdanění kapitálových příjmů v EU ztroskotaly. in: Bankovnictví 2/2000.
11. Taxation of savings income. 18. 9. 2001. http://europa.eu.int/scadplus/leg/en.
12. Vollziehungsverordnung zum Bundesgesetz ber die Verrechnungssteuer (Verrechnungssteuerverordnung, VStV). http://www.estv.admin.ch/data/dvs/indexd/index.htm.
13. Zahlstellensteuer zur Verhinderung von Umgehungen der neuen EU-Zinsbesteuerung. Archiv der Pressemitteilungen, Die Bundesbehörden der Schweizerischen Eidgenossenschaft 28. 2. 2001.

Appendices see next page.

Appendix 1 Taxation of interest income of natural persons in of the European Union

	Tax rate	Method	Tax rate – foreign citizens[10)]	Control system/since	International information exchange
Belgium	15	Withholding tax (at source) [1)]	0 – 15	no	no
Denmark	In the framework of income taxation [5)]		0 – 20	yes/1977 [2)]	Some countries
Finland	29	Withholding tax (at source) [1)]	0 – 15	yes/1979	Treaty countries
France	25	Prepayment [6)] [1)]	0 – 12	yes/1984	Some countries
Greece	15	Withholding tax (at source)	0 – 20	no	no
Holland	In the framework of income taxation [12)]		0 – 20	yes/1987 [3)]	no
Ireland	24 [4)]	Prepayment	0 – 15	yes/1992	no
Luxembourg	“Net” tax regulation [11)]		0 – 20	no	no
Germany	30	Prepayment [7)]	0 – 15	no	no
Portugal	20	Withholding tax (at source) [1)]	0 – 15	no	no
Austria	25	Withholding tax (at source)	0 – 10	no	no
Spain	25 [13)]	Prepayment	0 – 15	yes/1985	no
Sweden	In the framework of income taxation [8)]		0 – 20	yes/1986 [3)]	Some countries
Italy	27	Withholding tax (at source)	0 – 15	no	no
Great Britain	20	Withholding tax (at source) [9)]	0 – 10	yes/1952	Some countries

Notes to Appendix 1

1) The taxpayer has the possibility to opt for calculation of the tax in the framework of income tax.
2) An automatic system of control reports exists.
3) There exists an extensive obligation to submit information upon the request of tax offices.
4) The original rate was 10% for savings accounts up to 50 000 Irish punts, 26% in other cases.
5) Interest income must be included in income from capital (also interest expenses can be deducted from income from capital). The overall tax rate (the sum of state, local and church taxes) is, for example, in Copenhagen 61.7%.
6) All deposits with a fixed yield may be subject to a fixed payment in the amount of 15% (+10 per cent reserve), the use of which frees income from tax. The use of the deposit depends on the depositor. If the prepayment is not applied, income from a deposit is taxed together with other income. Certain deposit products are free of tax, for example a first deposit book, savings of young persons, building society savings; no provisions regulate interest payments relating to income from a current account.
7) From interest income a prepayment is made for the final income tax in the form of a withholding tax on interest , if interest payments exceed _1 601 for single persons or _3 202 for married persons. Withholding tax is withheld and transferred by the bank paying the interest.
8) The taxpayer receives a draft income tax return containing information on their taxable income (banks give data on bank interest payments to the tax authorities); the taxpayer may perform corrections to the draft income tax return and then submit it to the tax authority. The tax rate is 30%.
9) Persons with low income may request payment of interest income without tax deduction.
10) The specific tax rate depends on the respective agreement on limitation of double taxation.
11) The overall tax rate is 47.15%.
12) The overall tax rate is 60%.
13) The overall tax rate including local tax is 48%.

Appendix 2 Taxation of interest income in countries with transforming economies

	Tax rate	Method
Albania	10	Withholding tax (at source)
Czech Republic	15	Withholding tax (at source)
Estonia	0	–
Georgia	10	Withholding tax (at source)
Croatia	0	–
Latvia	0	–
Lithuania	0	–
Macedonia	0	–
Poland	20	Withholding tax (at source)
Slovakia	15	Withholding tax (at source)
Slovenia	0	–
Ukraine	20	In the framework of income taxation