

# TAX BARRIERS ON THE WAY TOWARDS AN INTEGRATED EUROPEAN CAPITAL MARKET: THE EU SAVINGS DIRECTIVE AS A CHALLENGE FOR CLEARING AND SETTLEMENT SYSTEMS

Joseph De Wolf

## ABSTRACT

*La creazione di un mercato finanziario europeo integrato, efficiente, liquido e sicuro è uno dei programmi più ambiziosi della UE. Tuttavia, i trasferimenti internazionali di titoli incontrano una così ampia divergenza di trattamento fiscale in seno alla UE, e in pratica le questioni di tipo fiscale rimangono un ostacolo reale alle transazioni internazionali ed allo sviluppo di un mercato finanziario europeo. Il Rapporto Giovannini ha già evidenziato le principali barriere fiscali esistenti.*

*Il contributo riflette sull'impatto della Direttiva UE sul Risparmio sulle barriere fiscali esistenti. Se, da un lato, la procedura adottata di scambio di informazioni può considerarsi un approccio positivo per il reddito riveniente dai conti di deposito presso gli istituti di credito, dall'altro, l'autore si chiede se non sia più adeguato un approccio diverso per i proventi da titoli a reddito fisso, negoziabili sui mercati mobiliari.*

*In particolare, l'organizzazione di un meccanismo di ritenuta fiscale a livello delle infrastrutture di compensazione e regolamento tramite meccanismi come quello belga X/N potrebbe aver incrementato i proventi fiscali degli Stati membri, dirottato l'importante onere amministrativo della raccolta dei dati su operatori più adeguati, affidato le responsabilità per la raccolta e lo scambio delle informazioni alle autorità competenti e infine essere riuscito pienamente a rispettare la sovranità fiscale degli Stati membri.*

## A BRIEF OVERVIEW OF THE GENERAL DEBATE

The Commission's Communication on clearing and settlement<sup>1</sup> to the Council and the European Parliament calls the creation of an integrated and efficient European capital market the most important and ambitious economic project currently under way in the European Union (EU).

Such a European capital market should be safe, liquid and offer facilities for the cross-border issuing, trading and holding of EU securities. The project is supported by a multitude of players, such as the European institutions, the European Central Bank (ECB); regulators and supervisors from the European System of Central Banks (ESCB)/the Committee of European Securities Regulators (CESR); the specialised committees, in particular the Giovannini Group; and, last but not least, the public and private sector, the clearing and settlement systems, national capital markets and the banking sector. All have a proper interest in the project and jointly contribute in their respective fields of competence.

The European capital market is to be the final link in a long chain of developments, starting with the liberalisation of capital movements, the single passport for financial institutions (e.g. credit institutions, investment firms, insurance companies, etc.), the creation of the ESCB, the single currency and a safe environment for financial transactions through EU projects such as Directive 98/26/EC of the European Parliament and the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (OJ L 166, 11.6.98, p. 45) and Directive 2002/47/EC of the European Parliament and the Council of 6 June 2002 on financial collateral arrangements (OJ L 168, 27.6.2002, p. 43).

The clearing and settlement systems clearly play a significant role in this project. Their role is currently the subject of intensive debate<sup>2</sup>, as a process of integration and consolidation is underway, and it is not certain that the political debate about their role can keep up with the pace of change in the industry. The debate is about the optimal degree of regulation that may enhance private initiative and competition, while meeting the need for a secure, balanced and institutional level playing-field for all operators. Clearing and settlement has a natural tendency to improve efficiency via economies of scale and to seek to consolidate markets. Member States, on the contrary, have a tendency to segment markets and to maintain boundaries, monopolies and sets of local rules in order to respond efficiently to their overall responsibility for the proper functioning of their own markets.

The Commission has given indications as to the way forward to improve the Community environment for cross-border securities clearing and settlement.

1 COM/2004/0312 def, "Clearing and Settlement in the European Union – The Way Forward".

2 "Standards for Securities Clearing and Settlement in the European Union", ESCB/CESR, September 2004. The Report's call for contributions received a large response.

Priority points on the agenda will be the elimination of existing barriers and of possible restrictive market practices, as well as the adoption of a common regulatory and supervisory framework, accompanied by appropriate governance structures.

The Commission also made it clear that it will respect the principles of subsidiarity and proportionality and the diversity of approaches in the different Member States with regard to market structures. Any further consolidation should be mainly market-driven, but only to the extent that this meets legitimate public policy concerns. The Commission adopts the approach suggested by the Giovannini group to remove existing barriers through a combined effort by the private and public sectors, and according to an appropriate sequence of actions. The Commission therefore envisages the creation of advisory and monitoring groups, the drafting of a Directive on clearing and settlement, and the organising of expert groups to tackle legal and tax issues.

The fiscal treatment of transactions in securities still diverges widely within the EU. As a consequence, tax issues remain in practice a fundamental obstacle for cross-border transactions. While legal insecurity regarding the settlement of financial transactions has to a considerable extent been removed through the implementation of relevant Community directives in all EU Member States, no such progress has yet been realised in the field of direct taxation.

The Giovannini Report<sup>3</sup> identifies these tax barriers. It suggests that one solution might be to allow investors to choose the preferred location of the holding of their securities. Such a solution, which would imply that exclusivity of taxation is given to the Member State where the security is located, would make sound competition possible between Member States in order to attract investors. However, it would also be contrary to the EU principle of fiscal sovereignty, which allows Member States to tax the income of securities held by their tax residents, irrespective of the location of the asset, as well as to levy a withholding tax upon the streams of income from securities passing through or originating in their jurisdiction. The Giovannini Report correctly observes that even such a solution would not solve all potential problems, as some investors might prefer to hold their securities in the local market so that national differences in the relevant tax regime would remain.

National differences in withholding taxes, capital gain taxation and transaction taxes are of a general nature, and are not specific to the securities and settlement systems environment. The Giovannini Report also stresses the negative impact of tax barriers resulting from disadvantageous domestic withholding tax regulations for foreign intermediaries, or from functionalities integrated into local settlement systems that reduce the possible recourse to alternative settlement systems and therefore reduce competition and weaken the optimal allocation of resources.

<sup>3</sup> Giovannini Report, November 2001, on “Cross-border Clearing and Settlement Arrangements in the European Union”, p. 50.

Fiscal barriers fully appear in the processing of cross-border transactions. There are numerous causes of inconsistencies<sup>4</sup>, such as:

- the differences in the tax treatment of income derived from equity or fixed-income securities, such as domestic withholding taxes, taxation of capital gains, permanent establishment exemptions, etc.;
- the fiscal treatment of securities lending, swaps or repurchase transactions;
- the definition of “beneficial ownership”;
- the formalities and documentation duties to obtain tax exemptions, tax vouchers or tax relief via other forms (e.g. affidavits, certificates);
- the scope of the tax reporting by the SSSs (securities settlement system) or (I)CSDs ((international) central securities depository);
- the fiscal status of intermediaries (e.g. US qualified intermediary status);
- the particular clauses of the bilateral treaties to avoid double taxation.

The position of the Commission towards the taxation of interests from fixed-income securities and dividends may for this reason have an important impact upon the further progress towards a European capital market.

## THE FUNCTIONALITIES OF CLEARING AND SETTLEMENT

We shall first briefly describe the functionalities of clearing and settlement.

Transactions in securities generally go through four phases: trade, confirmation, clearing and settlement. As there is no common legal definition for these operations, concepts are often used rather interchangeably, which does not simplify matters.

The first two parts of these transactions, trade and confirmation, allow the securities transaction to be legally constituted (which means the creation of a valid legal agreement for the securities transaction, whatever its type) and, preferably, also confirmed, in order to avoid errors or later disputes. These parts are handled by the traders’ front and back offices.

The third phase of the execution of a securities transaction is neither obligatory nor absolutely necessary, but is extremely useful. In the clearing phase, parties to securities transactions set off all mutual transactions through a process of compensation. The intention is to arrive at a single claim of securities and cash which must be settled by the respective debtors. The transactions are generally cleared through a so-called clearing house. The clearing of securities transactions may moreover be accompanied by legal novation of the obligations: the seller’s obligation to deliver the securities is taken over by a central counterparty (in principle the same as the clearing house), and the same is true for the buyer’s obligation to pay the price.

4 See M. J. Peters, “Clearing, Settlement and Taxation in Securities Markets: Why Law Does Not Meet Practice and How to Improve the Integration of European Securities Markets”, published doctoral thesis, University of Utrecht.

Finally, the securities transaction is settled: the securities are delivered and the price is paid. This can be performed on a gross settlement basis, in which case the obligations of the parties are executed individually and separately for each transaction, often in a so-called real time gross settlement process. If the securities transactions are cleared prior to settlement, then only the net balances are settled. The advantage of clearing is precisely that it drastically reduces the settlement process, and more particularly the need for settlement assets. However, even if the securities transactions are not cleared beforehand, the securities settlement systems can still net the settlement transactions (i.e. the so-called payment netting) rather than settling all instructions individually on a gross basis. The settlement can be arranged either by delivery versus payment (DVP) or by delivery free of payment.

In practice, the settlement, and more particularly the delivery, of securities is arranged through bookings on securities accounts. No physical security is handled or transferred between parties, unless this is expressly demanded, as may be the case in some jurisdictions where investors still prefer to receive physical bearer securities. In such cases, physical delivery will only appear in the last phase of the chain. Normally the transfer of property is organised through the debiting and crediting of book entries of fungible or dematerialised securities on securities accounts. Physical securities in bearer form are gradually disappearing in the Member States as they are costly, contain a high risk of loss, and may facilitate tax fraud and money laundering.

In a cross-border environment investors have a variety of possibilities to settle a transaction, depending on the market organisation, their position and the possibilities of access to the different market structures. They may address themselves directly to a local agent abroad, which will arrange the transaction with the foreign central security depository (CSD). If the investors are professional ones, they will normally operate through an ICSD, a custodian bank or global custodian specialised in custody of securities, or through a local CSD, if a link exists with the foreign CSD. The settlement of such cross-border transactions is more expensive than local transactions for a number of reasons, mainly because all markets are still functioning in a national environment as far as operational, regulatory, supervision and tax features are concerned, which makes the cost structure multi-layered.

As the Giovannini Report points out, the fragmentation of the markets with their integrated local tax functionalities might constitute an obstacle to the development of a functioning European capital market. However, one must also take into account the fact that most ordinary investors need to be able to address their local intermediaries, and expect simple, safe and transparent treatment. For this reason, it is also necessary to maintain local infrastructures at the lowest possible cost.

Fragmentation as such should therefore not necessarily be seen as a threat. The threat consists rather in the absence of low-cost, efficient links, that allow smooth interactions between the local infrastructures, which overrides the local

functionalities. The problem should not be the independence or proper functionality of the local infrastructure, but rather the absence or inefficiency of links or suprastructures interconnecting the local infrastructures.<sup>5</sup> And then again, tax obstacles may be at the heart of connection problems.

## THE BREAKTHROUGH REPRESENTED BY THE EU SAVINGS DIRECTIVE

Direct taxation is not subject to the European harmonisation process but remains a sovereign Member State competence. It is clear that taxation issues have an immediate and far-reaching impact on the architecture of the European capital market and on the functioning of clearing and settlement systems in the EU.

The EU Savings Directive<sup>6</sup> (“the Directive”) seems to mark a significant breakthrough and may accelerate the development of an integrated market.

Therefore, we should examine some aspects of the Directive and its possible impact on the European clearing and settlement systems in more detail.

Although the principle of the exclusive sovereignty of Member States in the area of direct taxation is in principle not questioned, the Directive indicates the need for further action at the EU level.

Some major achievements have already been made. In the field of company taxation, the Parent-Subsidiary Directive<sup>7</sup> stopped the cumulative taxation of company gains within a group structure, while the Code of Conduct, presented by the Tax Harmonisation Group chaired by Dawn Primarollo, was aimed at avoiding harmful tax competition between Member States. Today, the Commission is following a two-track strategy, addressing specific tax obstacles on the one hand, and working on a more long-term solution for a single EU-wide company tax base for EU cross-border activities on the other. The adoption of International Financial Reporting Standards (IFRS) shall boost this process.

The Directive originates in the adoption of the Council Directive of 24 June 1988<sup>8</sup>, which liberalised the free movement of savings. On this occasion a political agreement was reached between Member States to adopt in parallel another directive that would counter the tax avoidance that the liberalisation of the cross-border opening of savings accounts had made possible. While the first directive passed, however, the second failed and was quietly abandoned.

5 See also K. Kauko (2005), “Interlinking Securities Settlement Systems: A Strategic Commitment?”, ECB Working Paper, No 427, January.

6 Council Directive 2003/48/EC of 3 June 2003 on the taxation of savings income in the form of interest payments (OJ L 157, 26.6.2003, p. 38).

7 Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ L 225, 20.8.1990, p. 6).

8 Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty (OJ L 178, 8.7.1988, p. 5).

Tentative measures to impose a common EU withholding tax<sup>9</sup> also failed, among other reasons because of the objections of the United Kingdom due to concerns about the impact on the Eurobond market.

Finally, consensus was reached upon an EU legislative instrument at the Santa Maria da Feira European Council of 19 and 20 June 2000. The ultimate aim of the EU Savings Directive is to enable the effective taxation of interest payments in the beneficial owner's home Member State.<sup>10</sup> The exchange of information between Member States is accepted as a substitute for a common withholding tax. The entry into force of this Directive was made dependant on the simultaneous introduction of equivalent measures in the major competitive financial centres.<sup>11</sup> Three Member States negotiated a transitory regime, whereby they will not share information, but will instead levy a withholding tax, starting at 15% and progressively reaching 35% in 2011. The revenue of this withholding tax will be shared between the withholding state (25%) and the home state (75%).

The Directive contains a significant implicit message, namely the recognition of the failure of Member States to organise and coordinate an appropriate tax information exchange.<sup>12</sup> The EU Savings Directive admits this deficiency<sup>13</sup> and justifies on the basis of the subsidiarity principle the need for action to be taken on the Community level to adopt a minimum framework for the automatic exchange of information.

The European Court of Justice (ECJ) did consider that possible deficiencies in the exchange of information on tax matters might not justify restriction of the free movement of capital by Member States. In the *Commission v. Kingdom of Belgium*<sup>14</sup>, the ECJ examined whether a provision in the prospectus of a Eurobond loan issued by Belgium in the German market was compatible with the free movement of capital. This provision prevented Belgian residents from acquiring securities of this loan. Normally, Belgian residents would be liable to withholding taxes on interest income from Belgian government loans issued on the Belgian market, whereas this would not be the case with a Belgian Eurobond loan issued on the German market.<sup>15</sup> The Belgian government invoked the arguments of fiscal coherence<sup>16</sup>, the effectiveness of fiscal supervision and the need to prevent tax evasion. However, the Court tested these arguments against the required appropriateness and proportionality of such restriction. Taking into account the fact that nothing stops Belgian residents from acquiring hundreds of other Eurobond loans issued by other entities, these arguments did not pass the proportionality test. Still, a rather problematic issue remained in

9 As originally to be found in the so-called Scrivener proposal.

10 Recital 14.

11 The entry into force had to be postponed until an agreement for equivalent measures between the EU and the Swiss Confederation was reached. These measures have now been adopted and the term for a public call for a Swiss referendum will expire on 31 March 2005.

12 Recital 10.

13 See Recitals 10 and 16 of the EU Saving Directive.

14 Case C-478/98 of 26 September 2000, *Commission v Kingdom of Belgium*.

15 While no Belgian withholding tax will apply on interest received abroad, Belgian residents will have to declare this interest income in their yearly tax returns.

16 An argument that was accepted in case C-204/90, *Bachmann v. Belgian State*, 1992, ECR I-249.

that the Court did not take any account of the major difficulties faced by Member States to organise an effective mutual exchange of information, which would certainly apply to those hundreds of other Eurobond loans.

On this point the Directive represents a clear breakthrough and answers a genuine need of the EU. The questions that have been raised as to its compatibility with the freedom of movement of capital and payments, as provided for by Articles 50 to 60 of the Treaty establishing the European Community<sup>17</sup>, do not seem to undermine the legitimate motivation and grounds of the Directive concerning the need to legislate on the basis of the subsidiarity principle. The existing possibilities for the exchange of information among EU Member States certainly appear less than ideal for the EU.

Although Article 26 of the OECD's Model Tax Convention on the exchange of information on tax matters was updated in July 2004<sup>18</sup> and may over the coming years affect more than 2,000 existing bilateral tax agreements, it can no longer satisfy the needs of the EU. After having realised the free flow of capital in the EU, an efficient information exchange has become a necessity in order to maintain the Member States' taxation competences. An approach that only relies on the framework of conventions to avoid double taxation would require the current 25 EU Member States to conclude or modify among them a total of 320 bilateral tax agreements. Moreover, bilateral agreements are not satisfactory instruments on the EU level, taking into account the competency of Member States to interpret the terms of the agreements according to the definitions under the national legislation. While the OECD Model Tax Convention may remain a useful bilateral instrument for settling several types of taxation matters between Member States, it seems it can no longer be regarded as a workable instrument to organise the information on flows of interest and dividends in the EU.

Neither has the existing Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation (OJ L 336, 27.12.1977, p. 15) been able to satisfy the pressing need for automatic information exchange on interest and dividend income after the liberalisation of the capital markets.

The Directive puts all required tax data with respect to the fixed income of individual tax residents at the disposal of the Member States. The investment decisions of residents with regard to fixed-income securities or deposits in the

17 See two articles by M. Dassesse, "The EU Directive on Taxation of Savings: The Provisional End of a Long Journey ?", *EC Tax Review*, 2 (2004), pp. 41-46 (41); and "Does the EU Directive on Taxation of Savings Violate the Freedom of Movement of Capital?", *Butterworth's Journal of International Banking and Financial Law*, 19:1 (2004), pp. 12-17 (12).

18 The main improvements of Article 26 are the following:

- A paragraph has been added to prevent the so-called domestic tax interest requirements from hindering the exchange of information. The new paragraph holds that Contracting States should obtain and exchange information irrespective of whether they also need the information for their own tax purposes.
- A paragraph has been added to ensure that ownership information and information held by banks, financial institutions, nominees, agents and fiduciaries can be exchanged. This will prevent bank secrecy from being used as a basis for refusing to exchange information.
- The confidentiality rules in Article 26 have been changed to permit disclosure of information to oversight authorities.

EU will no longer be adversely affected by considerations of tax evasion, but will instead be the result of an objective comparison between the financial conditions on offer. Therefore the Directive might represent the tipping point towards the emergence an EU capital market for fixed-income securities.

Nevertheless, the question remains whether the easiest road has been chosen.

## THE EU SAVINGS DIRECTIVE AND THE CLEARING AND SETTLEMENT SYSTEMS

This contribution does not enter into the details of the Directive. For the purpose of this paper, it is sufficient to know that the EU Savings Directive puts an obligation upon *paying agents*<sup>19</sup> to inform their national tax authorities on the payment of fixed-income savings income in the form of interest payments to individuals who are identified as the beneficial owners and residents of another EU Member State. The information is then forwarded by the tax authority of the involved Member State to the relevant tax-resident EU Member State.

Some of the definitions in the Directive, such as ‘*beneficial owner*’, ‘*interest payment*’ and ‘*paying agent*’, have raised many questions, and the explanatory note of the Commission will hopefully provide the required clarification. It has also already been observed that some operators may be tempted to look for loopholes.<sup>20</sup> The Commission has foreseen this problem and has arranged for a three-yearly review to remedy any such deficiencies.<sup>21</sup>

However, it cannot be ignored that the banking industry, financial intermediaries and any operator qualifying as a paying agent under the Directive are all confronted with the nightmare of qualifying, interpreting, implementing and processing complex information at their own responsibility, and must then justify their actions towards their client base.

No distinction is made in the Directive on the basis of the nature of the right created by the financial instrument, be it an *intuitae personae* contractual right (e.g. cash deposit accounts) or a right *in rem* (e.g. bearer securities). Income from deposit accounts held in the books of financial institutions from Eurobonds in bearer form deposited with a financial intermediary, or from registered bonds, all become subject to identical measures of information exchange. Unlike deposits, where the financial institution has an overall oversight on a yearly basis of the client’s accounts, tradable securities may be actively managed on a daily or short-term basis, or be transferred, sold or subject to specific financial transactions, such as securities lending, repos, swaps, etc. And all these data, which may be dispersed over a wide variety of operators and intermediaries, will finally have to be collected, interpreted and classified.

19 The notion of a paying agent used in the EU Directive differs completely from the ordinary concept of a paying agent in the capital markets.

20 See P. Gerits et al. (2003), “The EU Savings Directive and Its Impact on the Banking Industry”, Baker & McKenzie, August. Part II states that: “Indeed, the challenge faced in identifying loopholes and planning for the Directive may be more a matter of choosing which method, rather than discovering a method” (p. 5).

21 Article 18.

This implies that the Directive not only places reporting duties on the most obvious intermediaries, namely the financial institutions, which are after all properly organised to manage the client's data flow, but also on any operator in the industry processing an interest payment and qualified as paying agent by the Directive. The Directive does not distinguish between different types of intermediaries and instruments, with the consequence that all sectors and types of intermediaries will be affected by reporting duties and tax data processing, which might eventually damage the efficiency of the exchange of information and boost the cost of market transactions. In a global European capital market, investors should be able to operate directly in the different market segments through competitive intermediaries. One might therefore fear that further market unification will be mirrored by a further fragmentation of data over the different market segments that may be involved in a securities transaction. This could multiply the number of involved paying agents for securities transactions.

The Directive's automatic exchange only addresses one type of savings income, namely interest payments, and excludes income from pension schemes, insurance policies or shares.<sup>22</sup> On several occasions, when no accurate information can be obtained, the Directive introduces legal presumptions, so that income may be qualified as an interest payment for the application of the Directive.<sup>23</sup> Information will therefore not always be accurate and will need to be treated very carefully by the tax authorities.

While the data exchange for income from deposit accounts is manageable, it is less certain that the same applies to the data on securities transactions on the EU markets.

Remarkably, for Member States falling under the Directive's derogation and applying the withholding tax, the Directive acknowledges that the period of holding of a security might not be known by the paying agent. Therefore, it allows the withholding tax to be levied without regarding the period of holding of the securities.<sup>24</sup> This may seem a practical solution, but in reality it means the end of cross-border access to such a market. This decision will make such a market segment unworkable for cross-border transactions, as the withholding tax burden will become extremely severe. The following example demonstrates the consequences.

Say that an Italian resident holds a Belgian government bearer bond with a yearly coupon of 5%. Under the Belgian tax regime, Belgian government bearer bonds do not qualify for any exemption of withholding tax unless they are registered and held for the whole interest period. Our Italian resident sells the bond on the secondary market. There will be no possibility of establishing the period of

22 The legal borderline between the different savings products is vague. Insurance products may qualify as fixed income instruments. But what about subordinated loans, profit-sharing bonds, discount bonds, index-linked bonds, convertibles, etc.? As the Directive takes priority over national legislation, the paying agents will have to look beyond the fiscal qualification of the type of income given in national legislation and will have to check the applicability and qualification as defined by the Directive.

23 For example Articles 6.2. - 6.4.

24 Article 11.3 of the Directive.

holding of the security unless the individual serial number of each security is registered at each transaction. This is in practice unfeasible. As a consequence, the Italian resident will first have to pay the pro rata compensatory indemnity for withholding tax, which is ordinarily applied between the seller and buyer, and will then once again suffer the Directive withholding tax.<sup>25</sup> However, this will not be the pro rata withholding tax for the period of holding, as this unfortunately cannot be established, so that the Directive's legal fiction applies and the withholding tax is calculated as if the Italian resident had held the security from the beginning of the interest period. This results in double taxation in Belgium, without the possibility of reimbursement, as this is unavailable under Belgian tax law. The story is not even over at this point, as the taxation power of Italy as the tax resident's home state fully remains.<sup>26</sup> We do not wish in this paper to further elaborate this example, but the least that can be said is that the Directive does not seem in this regard to improve the unification of the EU capital market.

Although the Directive does represent a breakthrough, it is also an extremely burdensome administrative instrument that shifts an important amount of work from the fiscal authorities to the industry, yet still entails substantial efforts on the part of the fiscal authorities to channel, process, verify and redress all the collected data.

Therefore, it is questionable whether the option of introducing a generalised reporting duty for all types of interest payments, independent of the type of instrument, is overall the most effective one. For negotiable securities, the withholding tax mechanism would offer numerous advantages, while the tax sovereignty of the Member States to choose between a withholding tax system or a globalisation of income need not be affected. A possible model for such alternative is described below.

## **THE BELGIAN X/N MODEL: AN INTERESTING MODEL?**

There is little doubt that a common withholding tax could make life easier and constitutes an efficient instrument for market integration. This was the original idea of the Commission, but no unanimous vote could be reached.

Member States have resisted the idea of a common withholding tax. Even if the alternative of a massive information exchange system may have frightened the Member States, a common withholding tax system on interest payments seems to have been seen as a greater threat, creating the fear of a possible EU withholding tax, to be redistributed among the Member States on macroeconomic parameters. This would then have signified a major breach of tax sovereignty. The system of data exchange seems to protect against such an evolution.

<sup>25</sup> Article 11.3 of the Directive. The Directive introduces the principle of withholding tax on income paid not by the debtor, but between parties on the occasion of transactions during the interest period.

<sup>26</sup> Article 11 of the Convention between Belgium and Italy to avoid double taxation.

While this resistance seems reasonable for income from deposits held with financial institutions on a contractual basis, the argument is less valid for income from securities transactions operated on the markets.

The Belgian X/N withholding tax system<sup>27</sup>, which is applied in the so-called X/N clearing and settlement system of the Nationale Bank van België/Banque Nationale de Belgique (NBB), introduces a very simple system to organise a differentiated and anonymous withholding tax that can be directly settled with the Belgian Treasury or with any EU Member State other than Belgium, provided that a link has been created between both national securities markets. This system should not affect the final tax sovereignty of Member States in any way, but should avoid the immense administrative burden on the paying agents.

How would such an EU withholding tax system work? Let us first examine the existing Belgian X/N model.

In the Belgian X/N system, the participants, as the financial intermediaries, keep two categories of securities accounts at the top level of the CSD/SSS, held in the accounts of the NBB: accounts for persons or entities exempted from withholding tax, and accounts for non-exempted persons or entities. These accounts are global accounts<sup>28</sup>, and the individual accounts are held on the lower levels in the books of the participants or sub-participants of the CSD/SSS. The identification and administrative attestation for tax purposes remain at the level of the immediate contractual relationship with the final client.

Taxation is organised at the level of the global accounts, and then cascades to the lower levels, without an additional need to exchange data on the individual account holders.

Securities transactions executed on “X” accounts (“*exempted accounts*”) are performed on a “gross” basis (meaning that no withholding tax applies on the payment of interest income). On “N” accounts (“*non-exempted accounts*”) the withholding tax applies and only net interest is paid or received by the account holder (either on coupon date or when buying or selling during the interest period). This withholding tax is calculated by the clearing system, which disposes of all required data (type of security, interest income and period of interest). To create a global market that allows transactions between exempted and non-exempted persons, a transitory account needs to be held by the Belgian Treasury, which functions as a valve to enable possible transactions between persons of different tax categories. The Belgian Treasury immediately receives the withholding tax *pro rata temporis* when an N account is debited and, conversely, advances the *pro rata temporis* withholding tax each time an N account is credited. A particular mechanism of debiting or crediting *pro rata* withholding is also put into place for the holders of X accounts to allow them to enter or withdraw securities from the common tax system environment into

27 Law of 6 August 1993 concerning transactions on certain securities.

28 Technically, these accounts are generally known as omnibus accounts.

the X/N clearing system, and vice versa. In this way, transactions between X and N accounts are made possible, one on a gross basis and the other on a net basis.

The advantages of such a system are clear: a global securities market is created with broad access to all types of issuers and investors, which can heighten the degree of market liquidity and efficiency. Withholding tax is collected and transferred by the clearing system to the Treasury in real time on all global transactions, without the need to identify or individualise, as all identification data exist on the lower levels and are subject to tax controls. This simplifies and improves tax collection. However, most importantly, this system avoids placing an administrative burden on the financial intermediaries, which do not have to exchange data or calculate withholding tax, but only have to pass on to the accountholders the withholding tax debt, which is established on the global top accounts of the X/N system. Of course, the financial intermediaries remain subject to tax controls on their correct classification of the security accounts into X or N accounts. This requires identification of the client, and the intermediaries bear a proper tax liability for errors. The tax authorities are in a position to receive all global data from the X/N system so that local controls can be efficiently organised and information can still be transmitted to the resident Member States according to the arrangements between the Member States' tax authorities. In this way Member States can rely upon a performant information exchange and maintain a sovereign choice as to the national fiscal regime applied to interest and dividend income<sup>29</sup> and the methods to avoid double taxation on this type of income.<sup>30</sup>

In this way the burden of processing the withholding tax, data handling and tax supervision is allocated to the most suitable levels with the most competent persons in charge. The processing of withholding tax is assigned to the clearing system at the top of the pyramid, so that it can work on the level of the global accounts, which allows a cost-efficient approach and advantages of scale. The exchange of information remains a primary task of the fiscal authorities.

This system can comply with any desired tax policy. It can provide exemptions on withholding tax for any type of income (Eurobonds, etc.), or for any type of tax entity or persons, depending on the tax policy.

Such a system can be linked to local systems of other Member States and could take into account the tax policy and withholding tax rate of these Member States. The system will even be directly operational for the tax collection of any Member State when its national Treasury holds an account with the system to be debited or credited according to the mechanism, described above and adjusted to satisfy the national tax regime's particularities.

<sup>29</sup> In some Member States interest and dividend income is taxed in a global income scheme; in other States this type of income is taxed distinctly.

<sup>30</sup> Different methods are applied by Member States to avoid double taxation, like tax exemption, tax credit, tax imputation, etc.

If national CSD systems in the EU all had a transition account with the different national Treasuries, withholding tax on income paid to tax residents of each Member State would in real time<sup>31</sup> be processed by the Treasury of the tax-resident Member State at the common EU withholding tax rate of 15%, or even directly at the national rate determined by each resident Member State. In parallel, an information exchange on income from residents, resulting from local controls on the lower level accounts held with the participants, would apply, allowing resident Member States to receive regular and systematic data information on their national tax residents that hold accounts abroad. This data exchange would not be as complete as the data exchange organised by the Directive, but it would be sufficiently systematic and thorough<sup>32</sup> to dissuade beneficiaries from tax evasion. Such a system would therefore entirely respect the Member States' sovereign taxation policies.

Could this taxation model improve the development of a European capital market? The essential characteristics of the X/N withholding tax mechanism certainly seem to offer some interesting perspectives, two of which stand out.

Firstly, the mechanism of levying and collecting withholding tax is situated on the top level of the suprastructure. Withholding tax levying and collecting is linked to the functioning of the global accounts and is disconnected from the individual holders of the accounts on the lower level. This characteristic minimises the administrative tax procedures while still providing permanent access to all relevant individual information.

Secondly, on the level of the global accounts, it becomes possible to multiply unlimitedly the number of types of X or N accounts based on the requirements of each Member State. A common EU withholding tax would no longer be necessary. A local SSS could easily keep 25 different global types of account, each one designed to apply the required withholding tax for a specific category as determined by each particular Member State, and connecting the global account to the transitory account of the relevant Treasury of each Member State, thereby enabling transactions between the holders of different types of accounts.

Such a mechanism can only be operational on the level of the suprastructures.

Progress towards achieving an EU capital market would require the creation of certain links. In a first phase, links will only be required between the national systems<sup>33</sup> and the different Treasuries. Links with the latter would allow the withholding tax to be immediately redistributed without any further

31 One of the advantages of the transition account with the national Treasury is that withholding taxes are immediately collected by the State on the transaction day itself without the loss of interest due to the administrative delays in the tax collection.

32 As the tax authorities of the Member States should all receive access to global data at the highest level, since this information is required to justify the debiting of each national Treasury's accounts, they can also immediately identify the origin of the global amounts of taxable income of their national residents in each other's jurisdiction, and can agree with the relevant Member State's tax authority on focused controls.

33 The system is already known and partially applied by Clearstream and Euroclear. In addition, some foreign tax systems – for example, the Italian Treasury – apply variants of the X/N model.

administrative burden. In a subsequent phase, direct cross-border access for issuers and investors would require further development of the links between the SSSs, (I)CSDs and Treasuries. This would be made easier with an X/N type taxation model, which could simplify tax administration, collection and redistribution.

Of course, administrative changes to the links between the SSSs and (I)CSDs would need to be implemented. The Member States' Treasuries and tax administrations would have to be involved in this process, which would represent a major European operation.

However, the burden of such an operation would rest upon the suprastructures and national authorities, and not on the thousands of intermediaries who are currently confronted with the encumbrances of complex data processing even though they are not necessarily organised to accomplish this task, or capable of perceiving whether any real progress towards a more efficient cross-border EU capital market has been made.

It seems that such a tax system might kill several birds with one stone. Member States' collection of fiscal revenues would be highly facilitated, while a significant step towards a single global EU capital market would have been taken. The competitiveness of national securities markets and clearing and settlement systems would improve. Responsibility for data collection, verification and exchange would remain essentially with the competent authorities, while correspondingly avoiding placing an administrative burden on the industry. All this might contribute to optimal capital allocation and to the creation and redistribution of welfare in the EU.