



An E.U. Withholding Tax?

A traditional problem for governments is how to tax the investment income of private assets held abroad. From World War I through the 1980s, European governments used capital controls—taxes or restrictions on international trade in assets—to prevent capital from moving abroad to escape taxation. During the 1980s, however, the economic integration of the European Union required national governments to remove such controls. At the same time, technological progress facilitated international trade in assets. The resulting integrated market requires governments to cooperate in tax enforcement or lose the ability to tax highly mobile capital.

Since 1989, the European Union has considered plans to prevent individuals from evading taxes on interest income by investing abroad. Germans, for example, have often invested money in Luxembourg and Switzerland to avoid high domestic taxes. On May 21, 1998, the E.U. Commission proposed that member states either withhold 20 percent of interest payments to residents of other E.U. states or report the payments to the tax office of the investor's state. This withholding tax would not apply to institutional investors, whose activities are easier to track. The Council of Ministers must unanimously approve the directive before the end of 1999 to make it law. The Council has tabled the measure as a result of objections from the government of the United Kingdom.

Opponents have three main objections to the withholding tax. First, because the directive does not exempt Eurobonds—bonds denominated in a currency other than that of the country in which it is sold—the withholding tax would drive business away from E.U. financial centers, primarily London, to locations outside the European Union. For this reason, critics compare the withholding tax to the U.S. Interest Equalization Tax of 1963, which spurred the relocation of the international

bond market from New York to other financial centers like London. The second objection pertains to the complex provisions in many bonds that require issuers to compensate the holders of the bonds for any tax. Such provisions would trigger the issuer's right to repurchase the bonds at par value. Because the market prices of the bonds are greater than the values for which they may be called, such provisions would greatly benefit bond issuers at the expense of bondholders. Finally, the withholding tax may be evaded successfully by moving offshore or by using sophisticated financial instruments.

Concerned about the position of London as an international financial center, the U.K. government recently proposed two alternate changes to the directive. The first proposal suggests specifying taxable forms of interest—instead of specifying exemptions—and presumably omitting Eurobonds from the list of taxable securities. The second plan grandfathers existing bonds from the tax, exempts future bonds that are held in a major clearinghouse system—a mechanism through which banks and securities houses settle payments—and applies the withholding tax only on holdings less than € 40,000 (about \$45,000).

Critics of the U.K. position protest that these changes would make the law too easy for individual investors to circumvent. In addition, the critics dismiss the danger to the London Eurobond market, noting that the retail market—to which the tax would apply—makes up only about 10 percent of the total Eurobond market. This objection, however, ignores the ease with which financial transactions can be moved around the globe. If retail transactions move out of London, many wholesale transactions might migrate as well.

At the time of this writing—October 15, 1999—the United Kingdom still threatens to veto the withholding tax unless the measure protects the interests of the City of London. The future of tax cooperation in the European Union remains in doubt.

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