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COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMISSION STAFF WORKING DOCUMENT

Accompanying the

Proposal for a

COUNCIL DIRECTIVE

**amending Council Directive 2003/48/EC on taxation of savings income in the form of
interest payments**

IMPACT ASSESSMENT SUMMARY

{COM(2008) 727 final}
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1. INTRODUCTION

The Taxation of Savings Directive (EUSD)

Council Directive 2003/48/EC on the taxation of savings income in the form of interest payments (EUSD) was adopted in 2003. The EUSD provisions started to be applied by Member States (MS) on 1 July 2005 at the same time that Andorra, Liechtenstein, Monaco, San Marino and Switzerland began to apply equivalent measures under Agreements with the EC. From the same date 10 dependent or associated territories of the Netherlands and the UK began to apply the same measures as those of the EUSD.

The ultimate aim of the EUSD is to allow each MS to apply its domestic tax rules on interest payments that its resident individuals receive from paying agents established in other MS.

In order to achieve this ultimate aim, the EUSD provides for an automatic exchange of information on such payments. However, during a transitional period, three MS (Austria, Belgium and Luxembourg) apply a withholding tax and share the revenue with the MS of residence of the beneficial owner, instead of providing information.

The Commission proposal for amendments to the EUSD is based on the first of the reports that the Commission has to present to the Council every three years on the operation of the EUSD in accordance with its Art. 18. This Article also provides that the Commission shall, where appropriate, propose to the Council any amendments to the EUSD that prove necessary in order better to ensure effective taxation of savings income and to remove undesirable distortions of competition.

Following the first revelations in February 2008 about fraud cases, involving EU residents and foundations in Liechtenstein, there was a debate at the Council on 4 March 2008, and the Council "...called on the Commission to accelerate preparation of a report on the implementation of the Directive 2003/48/EC since its entry into force on 1 July 2005...". On 29 April 2008, and prior to the presentation of the Article 18 report, a Commission Staff Working Document [SEC(2008) 559] entitled "Refining the present coverage of Council Directive 2003/48/EC on taxation of income from savings" served as the basis for an oral presentation by the Commission to the Council on 14 May 2008. This working document highlighted the main problems identified and raised a number of issues needing clarification with a view to possible refinements to the scope of the EUSD.

The report under Art. 18 of the EUSD was adopted by the Commission on 15 September 2008 [COM(2008) 552] and presented to the Council.

The report was accompanied by a Commission Staff Working Document "presenting an economic evaluation of the effects of Council Directive 2003/48/EC on the basis of the available data" [SEC(2008) 2420]. This working document provides quantitative approaches to evaluate the functioning of the EUSD. It analyses the evolution of certain proceeds from investments. In addition, the analysis looks at the effects of the implementation of the EUSD on some investment patterns. The last section of the document offers a statistical analysis of the impact of the introduction of the EUSD on savings and on bank deposits.

2. REVIEWING THE EUSD

The report and the amending proposal are the result of a long process of analysis and open consultation. This process was launched in 2005 when Commission staff started examining the operation of the EUSD and its interpretation with experts from the tax administrations of MS in two working groups, *Working Party IV on Direct Taxation*, and the *Working Group "Administrative Cooperation in the field of Direct Taxation"*. The first group has concentrated on the legal and practical issues related to the substantive content of the EUSD, whilst the latter group has helped to ensure a monitoring of the correct implementation of the EUSD concerning exchange of information and transfer of funds relating to the revenue sharing. It has also helped to develop the format for information exchange.

In parallel with the groups involving the tax administrations of MS, a special *Expert Group on Taxation of Savings*, with tax experts from banking, insurance, investments funds, asset management and related sectors in the EU, was set up in early 2007. This group provided the Commission with the viewpoint of EU market operators on the application of the EUSD and, at the same time, facilitated a first scrutiny of the possible impact on markets of any amendments to the EUSD which could come up for consideration as a result of the review process.

More detailed information on the review process can be found on the following webpage:

http://ec.europa.eu/taxation_customs/taxation/personal_tax/savings_tax/savings_directive_review/index_en.htm

Despite the efforts made by MS and market operators to provide the Commission with statistics, the quality and quantity of the statistics received are not sufficient to make a detailed quantitative analysis. However, the lack of quantitative data is not "per se" an obstacle to make a proper analysis of the problems identified during the consultation process or to propose adequate solutions. Furthermore, there is a need to anticipate developments based on the input of the stakeholders, which clearly recognise the need for improvements in the system.

3. IDENTIFIED PROBLEMS AND NEED FOR SOLUTIONS

The consultations with business and national administrations have shown that the coverage of the EUSD is not as wide as in principle intended according to the unanimous Council conclusions of 27 November 2000 on which the EUSD is based, and also that the EUSD provisions contain loopholes. Such loopholes are detrimental to the effectiveness of the EUSD, whether it is applied in the form of automatic information exchange or, transitionally, through the levying of a withholding tax. They are also a potential source for market distortions because they hinder a consistent treatment of comparable situations.

There is evidence that, for payments made within the EU, the EUSD can be circumvented by:

1. making use of intermediate investment vehicles (legal persons or arrangements) which are not covered by the current formal definition of beneficial owner (that refers only to individuals) and which are not currently obliged to act themselves as paying agents, and/or
2. rearranging one's investment portfolio in such a way that income remains outside the definition of interest payments of the EUSD, whilst benefiting from limitations of risk, flexibility and agreed return on investment that are equivalent to debt claims.

A balanced solution to close the loopholes needs to take into account all of the three essential elements of the EUSD, namely “beneficial owner”, “paying agent” and “savings income in the form of interest payments”, as well as the administrative burden on paying agents and on MS, the need to safeguard MS' tax revenue and the competitiveness of the EU financial sector.

Any delay in finding solutions for ensuring fairer and more consistent coverage of the measures, could result in future more evident market distortions between comparable products and investment vehicles.

For the three MS operating the transitional regime (as well as for those non-EU territories and countries cooperating in the form of a withholding tax) the time constraint is of particular importance since the risk of distortion between comparable products will increase in parallel with the increase of the rate of the withholding tax to 35% from 1 July 2011.

Besides the loopholes mentioned above, the consultation with market operators has also revealed that the application of the provisions of the EUSD by paying agents may in certain cases be burdensome because of lack of clarity. "This is the case of (i) the definition of 'interest payment' and 'paying agent', (ii) the definition of 'residual entities' (*to be considered as paying agents on receipt of an interest payment*) and (iii) the formulae that may be used in different Member States to determine whether a fund or a particular fund event falls under the Directive", as it has been pointed out by the European Banking Federation (EBF), which represents most of the paying agents already involved in the application of the EUSD.

The following table provides a list of the identified problems according to the need for action:

| Table 1: Hierarchy of identified problems |
|--|
| 1. Use of intermediary structures not covered by the present scope, notably some legal arrangements , and lack of clarity on the “paying agent on receipt” rule (Art. 4(2)); |
| 2. Different treatment of investment funds which are not authorised UCITS in accordance with Directive 85/611/EEC ("non-UCITS"), depending simply on the legal form of these non-UCITS (incorporated always excluded from the scope of the EUSD whilst non-incorporated are always included) |
| 3. Use of comparable products to debt claims (certain structured products and certain life insurance contracts) |
| 4. Deficiencies in the rules for identification of beneficial owners, notably concerning the determination of their residence for the purpose of the EUSD; |
| 5. Coping with the use of conduit vehicles established in third countries in a way which is coherent with freedom of capital movements (parallel need to replace the certificate procedure to avoid the withholding tax with the simplest procedure of voluntary disclosure of information to the tax authorities) |
| 6. Lack of statistics from MS. Too limited use of the Tax Identification Number of beneficial owners which make the information more difficult to be used by the MS where they are resident. |

4. POSSIBLE SOLUTIONS

When assessing the various options, it should be kept in mind that the EUSD essentially relies on paying agents for the execution of its provisions. Therefore, due account has to be taken of the Lisbon Strategy and the better regulation initiative, which involves, for example, limiting administrative burdens and unnecessary costs for businesses, as well as of the principle of proportionality. MS should therefore be prepared to agree on solutions whereby any additional administrative burden for making the provisions of the EUSD more effective would be placed as far as possible on the tax administrations, which would benefit from an increase in tax revenue, or on market operators that are currently less involved, rather than on those market operators (such as banks and asset managers) that already make a significant contribution to the functioning of the EUSD.

Another constraint is the relatively limited territorial coverage of the EUSD as well as of the Agreements providing for the same or equivalent measures. It is difficult to make a proper assessment of the effects that any extension of the scope of the EUSD could have on capital flight to third countries. Even if the examination of the available data does not establish that the application of the Directive led to any change in the geographical composition of interest-bearing savings, any option for strengthening the effectiveness of the EUSD should take careful consideration of the international aspects.

The Commission continues to pursue the objective of promoting the application, by important non-EU financial centres, of measures equivalent to those applied by the MS. However, it is also relevant to consider, while having due regard to the free movement of capital laid down in the EC Treaty, whether provisions should be added aimed at tackling the attempts of EU resident individuals to circumvent the EUSD by channelling interest payments, made in the EU, through untaxed “shell” entities or arrangements located outside the territory of the EU or that of the jurisdictions applying equivalent or the same measures to those agreed at EU level.

Taking this into account, the Commission services have identified the following four options with their respective advantages and disadvantages (the impact of the different options is summarised in table 2 at the end of this document):

Option 1 – No action

| Option 1 | Action |
|-----------------|---|
| No action | Maintaining the status quo, i.e. "Do nothing" |

Option 2 – Amendments to ensure a better implementation of the unanimous agreement reached by the Council on 27 November 2000 about what should be the substantial content and aim of the EUSD

Option 2 basically means using the 27 November 2000 Council conclusions on what should have been the content of the then future EUSD as a benchmark, seeking to close **unintentional** loopholes.

| Option 2 | Action |
|---|---|
| <p>Amendments to ensure better coverage according to Council conclusions of 27.11.2000</p> <p>Limiting the administrative burden for paying agents in respect of the same conclusions</p> | <ul style="list-style-type: none"> - Extension to all collective investments vehicles - Extension of paying agent on receipt rule to legal arrangements (trusts) - "Home country rule" and solution to the "passive receipt" issue |

Option 3 – The same amendments as those under option 2, in combination with amendments to close as far as possible all loopholes and extend the coverage to all products which can be assimilated to interest-bearing instruments

This option involves extending the scope of the EUSD to benefits from those life insurance contracts which are competing with debt claims and investment funds. It also involves extending the scope to income from those securities which are equivalent to debt claims, because virtually all of the capital invested is protected at the end of the duration of the contract, and because the return on capital is defined at the issuing date although the product is not formally composed of debt claims.

The 'look-through approach' for beneficial owners would only apply to payments to certain structures established in selected non-EU jurisdictions which are not effectively taxed there.

| Option 3 | Action |
|--|--|
| <p>Amendments to close as far as possible all loopholes and to prevent distortions</p> | <ul style="list-style-type: none"> - Extension not only to all investment funds, but also to securities equivalent to debt claims and to those life insurances with low biometric risk investing in debt-claims, funds and equivalent securities - Extension of the “paying agent on receipt” rule not only to arrangements (trusts) but also to untaxed entities with legal personality (such as many foundations) - “Look through approach” for payments to certain untaxed structures established in certain third countries or jurisdictions. Eliminating the certificate procedure for avoiding the withholding tax. - Making more use of the available information for establishing the residence of the beneficial owner. |

Option 4 – Amendments to enlarge the scope of the EUSD to include all legal persons and all savings income

At the Ecofin Council in March 2008, a number of MS expressed their wish to extend the scope of the EUSD far beyond the Council conclusions of 27 November 2000. However, there are certain constraints to be considered:

—Withholding tax (even if transitional for three MS) is a suitable mechanism only if the net income is known. This is rarely the case for forms of income like capital gains. Also, the rules on capital gains taxation vary considerably. The levying of a withholding tax on the full sales proceeds would be disproportionate.

— Covering dividends and all investment income payments to corporate recipients, as suggested by at least one MS, could lead to multiple reporting and to multiple layers of withholding tax.

The general framework for administrative cooperation (Directive 77/799/EEC and its possible amendments), based only on information exchange, would seem more appropriate for these income payments.

| Option 4 | Action |
|--------------------|--|
| Much broader scope | Extension to payments to all legal persons and to all types of investment income (dividends, capital gains, “out payments” from genuine life insurance contracts and pension schemes, etc) |

5. PREFERRED OPTION AND CONSEQUENT POLICY ISSUES

After the analysis and consultation process, option 3 appears to be the preferable option at present. The first option (i.e. no action) should be rejected for not closing the current loopholes in the EUSD that have a potential negative impact on public revenues and on competition. Furthermore, some market operators consider that some aspects of the EUSD need to be clarified.

In comparison with option 2, the costs that would be incurred under option 3 by current paying agents and new paying agents should be outweighed by less distortion between similar products and by a better impact on the budget of MS.

Option 4, although more comprehensive than option 3, would be more costly and could lead to redundancies and double withholding. Therefore, option 4 does not seem to respect the principle of proportionality with regard to the objectives of the EUSD.

Any amendments to the scope of the EUSD would make necessary a review of the agreements with the 10 dependent and associated jurisdictions that apply the same measures. As far as the 5 non-EU countries that apply equivalent measures are concerned, the Council would have to assess whether the current agreements would still provide or not for equivalent measures to the amended EUSD. However, it seems that some of the proposed amendments under option 3 (notably concerning the "paying agent on receipt" mechanism) and definitely most of the

proposed amendments under option 4 would make it advisable to ensure a parallel change in the agreements signed with these 5 non-EU countries.

| Table 2: Condensed overview of the IA analysis | | | |
|---|--|--|--|
| Available Options | MS' budget protection | Efficiency | Financial Market |
| Option 1 | - <i>(risk of budgetary losses)</i> | ≈ <i>(no additional administrative burden but maintenance of existing one)</i> - <i>Poor statistics</i> - <i>Lack of clarity</i> | - <i>(potentially more distortions)</i> |
| Option 2 | + <i>(better protection)</i> | - <i>(greater administrative burden)</i> + <i>More clarity/ Better statistics</i> | + <i>(Less distortions between savings products)</i> |
| Option 3 | + <i>(better protection)</i> ++ <i>Horizontal equity</i> | - <i>(greater administrative burden)</i> + <i>More clarity/Better statistics</i> | ++ <i>(Less distortions between savings products with debt-claim features and/or capital protection/Less distortions between paying agents already covered and other entities and arrangements)</i> |
| Option 4 | + <i>(better protection)</i> +++ <i>Horizontal equity</i> | -- <i>(greater administrative burden)</i> - <i>Redundancy of information and multiple layers of withholding tax</i> + <i>More clarity/Better statistics</i> | +++ <i>(Less distortion between all savings products and intermediate structures)</i> |