COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION TO THE COUNCIL

in accordance with Article 18 of Council Directive 2003/48/EC on taxation of savings income in the form of interest payments

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Introduction

Art. 18 of Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments (the "Directive") states that "*The Commission shall report to the Council every three years on the operation of this Directive. On the basis of these reports the Commission shall, where appropriate, propose to the Council any amendments to the Directive that prove necessary in order better to ensure effective taxation of savings income and to remove undesirable distortions of competition.*"

This first report draws on consultations held with the EU Member States' ("MS") tax administrations, data provided by them on the first two tax years of application, and findings of an Expert group set up by the Commission in 2007 to seek advice from business sectors concerned or likely to be concerned by the Directive. For more details, see:

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

The Report covers the transposition and implementation of the Directive, and sums up the economic evaluation (details in the Commission Staff Working Document SEC(2008)2420) and the Commission's advice on the need for changes.

1. TRANSPOSITION AND IMPLEMENTATION OF THE DIRECTIVE

All MS have transposed the Directive and started applying the implementing rules from the scheduled dates (i.e. 1 July 2005 and, for Bulgaria and Romania, 1 January 2007). The Commission has so far opened two infringement procedures concerning the implementation of the Directive. A letter of formal notice has been sent inviting the two MS concerned to submit their observations. One case relates to incomplete transposition of Art. 4(3), allowing entities which are paying agents under Art. 4(2) to opt to be treated as a UCITS[1] for the purposes of the Directive. The other concerns the non-application of the Directive where the beneficial owner has "non-domiciled" status. The MS concerned considers that the Directive is not applicable if the beneficial owner is exempted in his MS of residence. The Commission does not share that view.

The Commission has monitored the exchanges of information made using a common format based on the OECD Standard Magnetic Format and the CCN-Mail 2 channel of communication. All exchanges in 2006 and 2007 took place on time and without technical problems. However, especially during the first year, MS reported some difficulties in identifying taxpayers, due to lack of information on their tax identification number ("TIN") or date/place of birth. The Commission facilitated the reporting of some statistical data and hosted meetings to allow tax administrations to exchange experience.

[1] Undertakings for collective investment in transferable securities authorised in accordance with Directive 85/611/EEC

2. ECONOMIC EVALUATION

Data from MS are available for the second half of 2005 and for 2006. Longer time series, including the period prior to the introduction of the Directive, would have made it possible to better assess its effects.

2.1 Data from participating countries

Collecting and reporting this type of data is a new task for many countries which might explain why values are missing especially on information exchange. Additionally, definitions of data treatment have not yet been agreed. These factors restricted the analysis that the Commission could perform.

Unsurprisingly, the largest economies exchanging information as provided in Articles 8 and 9 report the highest values. UK reported EUR 9.1 b for payments made from 1 July 2005 to 5 April 2006 (end tax year).

The major part of revenue from the withholding tax in 2005 and 2006 was raised in Switzerland and Luxembourg, which respectively accounted for more than 45% and 22% of the total revenue. In the tax years 2005 and 2006, the largest beneficiaries of withholding tax revenues were Germany (EUR 192.7 mio) and Italy (EUR 112.9 mio). Belgium received more than EUR 71 mio, mainly from Luxemburg (74% of the total).

2.2 Results from data sources

The Bank for International Settlements (BIS) collects data on the external positions of banks in about 40 reporting countries. BIS has provided non-publicly available data on bilateral cross-border loans and deposits for its reporting countries (only Singapore and Macao refused to disclose their bilateral data) for the period 2000-2007. Countries were classified into three categories: those applying the withholding tax under the Directive and the related agreements, those applying the exchange of information under these legal provisions and third countries. Notwithstanding structural breaks in the data, the share of withholding tax countries as a % of total deposits has decreased from 35.0% to 29.3% between mid-2003 and mid-2005 but stabilised after the introduction of the Directive. Countries that exchange information have a larger bank to non-bank[2] deposit ratio and their share of non-bank deposits has slightly decreased, albeit this occurred before the Directive came into force.

EUROSTAT data analysed includes the aggregated interest income split by recipients for 20 EU Member States during the years 2000 to 2006. Here again, the analysis does not show any significant change following the implementation of the Directive. The share of interest received by households in the total interest received by individual and corporate recipients has decreased but this is mainly due to an increase in financial corporations' receipts. Equally, the share of interest in total property income received by households has declined in favour of dividends but this phenomenon started already in 2000.

Finally, the available data on UCITS and non-UCITS[3] between 2002 and 2007 provided by the European Fund and Asset Management Association shows that their share remained constant at 78% and 22% respectively. The only noticeable evolution is a gradual decrease of UCITS investing in bonds from 29% to 19.5% of the total, mostly for the benefit of those

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[2] Here "bank" refers to deposits by banks and "non-bank" to deposits by others including individuals and companies

[3] Undertakings for collective investment in transferable securities **not** authorised in accordance with Directive 85/611/EEC

investing in equity. Here again, this is a phenomenon present prior to the introduction of the Directive.

3. POSSIBLE IMPROVEMENTS

The Directive has proven effective within the limits set by its scope. It has also had indirect, non measurable, positive results in enhancing taxpayers' compliance with their obligations to declare interest income. However, the review process evidences that the current coverage of the Directive is not as wide as the ambitions expressed in the unanimous Council conclusions of 26 and 27 November 2000.

Therefore the Commission advocates certain amendments to address the following issues:

Beneficial ownership;

Definition of paying agent;

Treatment of financial instruments equivalent to those already explicitly covered;

Procedural aspects.

Commission Staff Working Document SEC (2008)559 "Refining the present coverage of Council Directive 2003/48/EC on taxation of income from savings" ("CSWD 559"), together with other material available on the webpage mentioned in the introduction, complements the analysis of the solutions presented below.

3.1 Beneficial ownership and payments to entities and arrangements established within and outside the EU

In line with the ultimate aim of the Directive, Articles 1 and 2 deal only with interest payments made for the immediate benefit of individuals and not with payments to legal entities and arrangements. This targeted scope may provide individuals resident in the EU with opportunities to circumvent the Directive by using an interposed legal person or arrangement.

As explained in Section 2.1 of the CSWD 559, an indiscriminate extension of the Directive to cover all payments to legal entities and arrangements established in other MS would not seem an appropriate solution. The achievement of the ultimate aim of the Directive requires that *both* the individual who is the beneficial owner *and* his MS of residence are known. Furthermore, it would be of no help where the EU resident individual invests through an intermediate legal person or arrangement established in a non-EU jurisdiction (possibly subject to low or no taxation on interest income).

A more efficient solution, in line with the Directive's present scope and its ultimate aim, would consist of asking paying agents to use, when not disproportionately burdensome, the information already available to them about the actual beneficial owner(s) of a payment made to a legal person or an arrangement ("look-through" approach). This is similar to what is already required under Art. 2(2) for payments made to individuals who are known not to be the actual beneficial owner. Useful indicators are the "customer due diligence" measures that financial institutions and professionals within the EU are obliged to apply to fight against money laundering[4]. These provide practical criteria to be used by such institutions and

[4] Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing

professionals to identify the individual beneficiary on whose behalf a corporate or other legal entity or an arrangement concludes a transaction.

It should nevertheless be noted that these criteria are **not always relevant** for identifying the beneficial owner for the purposes of the Directive. Where economic operators established in the EU make interest payments to other economic operators (entities or arrangements) also established in the EU and therefore falling within the definition of "paying agent", a clarification of the definition and the obligations of paying agents (see section 3.2) seems a more reliable and proportionate solution than a mere "look-through" approach based on "customer due diligence" measures. A selective application of the "look through" approach could, however, be considered for payments to specific categories of legal entities and arrangements established in targeted jurisdictions **outside** the EU, likely to be used for tax evasion by EU resident beneficial owners. A list of those jurisdictions and their relevant entities and arrangements would then have to be annexed to the Directive. Procedures should be provided for adapting the annex to evolving needs.

In parallel with such a selective application of the "look-through" approach, it would be worth clarifying the responsibility of the EU economic operators when they are aware that an interest payment made to an operator established outside the territorial scope of the Directive (and of the related agreements) is made for the benefit of an individual, known by them to be a resident of another EU MS and who can be considered their customer. This would also help to prevent a possible misuse of the international network of financial institutions (branches, subsidiaries, associated or holding companies) to circumvent the Directive (and the agreements).

3.2 Definition of paying agent

Experience so far raises questions about the appropriateness of the definition of paying agent contained in Art. 4. While the broad concept of "*economic operator who pays interest to or secures the payment of interest for the immediate benefit of the beneficial owner*", in paragraph 1, has proved to be relatively well understood and does not appear to need major changes apart from those clarifying the responsibility of these agents for payments to parties outside the EU (see last paragraph of section 3.1), the additional concept of "paying agent upon receipt" developed in paragraphs 2 to 5 of the same Article seems to have generated more uncertainty. While causing costs for the EU economic operators, it has not produced all the results expected by MS. Some economic operators, notably banks, have called for this concept to be abandoned.

Without alternative mechanisms covering payments to intermediate structures within the EU (like an extended "look-through approach", cf. third paragraph of section 3.1), this could however encourage individual beneficial owners to make extensive use of such structures to circumvent the Directive. Recent cases of tax evasion, involving non-EU countries already cooperating with the EU on taxation of savings, have shown that, where the "paying agent upon receipt" concept is not consistently implemented, room is left for abuse and distortions. Investment funds regulated at EU level, whose income is taken into account for the purposes of the Directive (Art. 6), could face unfair competition from other intermediate investment structures, "de facto" excluded from the main definition of paying agent in Art. 4(1) since payments made by them, even if generated by investment in debt claims, do not legally qualify as interest payments.

Rather than abandoning the "paying agent upon receipt" concept, the Commission would suggest clarifying this concept to ensure its consistent application. A possible way forward would be to pass from the present approach, where the main focus is on the upstream economic operator paying interest to the entities concerned, to an approach based on a

"positive" definition of the intermediate structures to be charged with obligations to act as a "paying agent upon receipt".

This approach makes clear that these intermediate structures **must** apply the provisions of the Directive insofar as any of their beneficial owners is an individual who is resident in another EU MS. This would happen **upon receipt** by these structures **of any interest payment** as defined in Art. 6, from **any upstream economic operator**, not only those established in other MS (Art. 4(2), last sentence) or in the same MS (Art. 4(4)), but also those outside the EU. This would improve the effectiveness of the Directive and better safeguard fair competition between upstream economic operators within and outside the EU.

In order to avoid market distortions, a "positive" definition of the structures acting as "paying agent upon receipt" should be based on substantial elements rather than on their legal form. The decisive criteria should not be whether the structure is an arrangement or an entity or whether it has legal personality or not. In view of the aim of the Directive, the Commission favours a definition including **all** entities and arrangements **which are not taxed on their income**, **including income covered by Art. 6**, **under the general rules for direct taxation** applicable in the MS in which the entity or arrangement has its main centre of administration and can be considered to be resident. Only the following entities and arrangements should be excluded:

Investment funds covered by Art. 6;

Pension funds and assets relating to life insurance contracts;

Entities and arrangements set up exclusively for charitable purposes.

The option in Art. 4(3) to be treated as an investment fund under Art. 6, would be maintained only for those entities and arrangements whose assets or income are not legally attributable to any beneficial owner at the moment of receipt of the payment. If they do not exercise this option, they could be obliged to act as "paying agents upon receipt" and to treat as beneficial owners those individuals who contributed to their assets.

A "positive" list covering, for each MS, the categories of entities and arrangements to be considered as "paying agents upon receipt" would be annexed to the Directive, and procedures would be provided for adapting this annex to evolving needs. The current obligations on "upstream" economic operators under Art. 4(2), last sentence (and Art. 11(5)) would be maintained only for interest payments made to those entities and arrangements in other MS that, having regard to their MS of residence, are included in this "positive" list. However, the list would only have indicative value for the MS of which the entities and arrangements corresponding to the definition of "paying agent upon receipt" are residents: these MS should take the necessary measures to ensure that **all** such entities and arrangements comply with their obligations, regardless of whether they are included in the positive list and of the information actually received from foreign upstream economic operators.

3.3 Income included in the scope

In accordance with its title and its preamble, the Directive is essentially aimed at ensuring taxation of savings income in the form of interest, which is taxable under rather homogeneous criteria in all MS. Through the adoption of the Council conclusions of 26 and 27 November 2000 on the essential content of the Directive, it was *de facto* acknowledged that sticking to a formal definition of interest payment would not be effective and could lead to undesirable distortions of competition between direct and indirect investment in debt claims. In addition to Art. 6(1)(a) and (b) of the Directive, where interest is defined as income from debt claims in conformity with art. 11 of the OECD Model Tax Convention on income and capital, it was

therefore decided to extend the definition also to interest income obtained through the intermediation of some investment vehicles (Art. 6(1)(c) and (d)).

When the Directive became applicable in 2005, it was apparent that further refinements would be advisable to take account of the evolution of savings products and of the behaviour of investors. Domestic tax systems have also evolved over time to assimilate the treatment of income from some types of innovative financial products to interest from debt claims.

The original choice to exclude all innovative financial products from the scope of the Directive (ECOFIN Council conclusions of May 1999 and November 2000) was accompanied by an express statement that this issue should be re-examined on the occasion of the first review of the Directive. There is a need for clarity on which financial instruments would be brought into the scope of the Directive and a need for consistent and simple solutions. The aim should be to find a definition covering all securities that are equivalent to debt claims so as to ensure the effectiveness of the Directive in a changing environment and to preventing market distortions.

Annexing to the Directive a list of the types of instruments concerned does not seem workable. Instead, criteria should be enshrined in Art. 6(1) in order to allow the paying agents to identify instruments falling within the Directive. As the technical characteristics of the instruments, like their composition or the link between their performance and income of debt claims, are frequently not known by the paying agents, practical criteria to extend the scope of the Directive to those securities which are equivalent to debt claims should rather make reference to how the investors appreciate the securities concerned. One could fairly consider that an individual investor appreciates as equivalent to debt claims those securities whose risk is known, because of the prospectus or other compulsory information to be provided by paying agents to the investors, and is not higher than that of debt claims. This would result in adding to the scope of the Directive any income from securities where the capital is totally or almost totally protected and the return defined ex ante, bearing in mind that these securities, while in principle equivalent to debt claims from an investor perspective, need not be composed of debt claims but could be based for instance on gains from shares.

In parallel to the re-examination of the treatment of innovative financial products, other refinements to the current definition of interest payment could be considered in relation to investment funds, technically defined as undertakings for collective investment (Art. 6(1)(c) and 6(1)(d) of the Directive).

As regards undertakings for collective investment established in the EU, Art. 6 of the Directive at present explicitly covers only income obtained through UCITS funds (cf. footnote 1). Other collective investment schemes authorised under national regimes of MS and known in the EU as “non-UCITS” are not fully captured by the Directive. Their treatment varies between those non-UCITS with legal personality (incorporated funds) and those non-UCITS that lack legal personality (unincorporated or "contractual" funds and trusts, etc.). The former are not subject to the obligations laid down by the Directive, whereas unincorporated non-UCITS are subject to the Directive as “paying agents on receipt” (Art. 4(2)). The result is an asymmetry in treatment between UCITS and unincorporated non-UCITS on the one hand, and incorporated non-UCITS on the other. This disparity in fiscal treatment between different categories of investment funds in the EU is neither in the interest of the Internal Market nor was it intended under the ECOFIN Council conclusions of November 2000 defining the essential content of the Directive. This could justify an amendment to Art. 6(1)(c) and (d) of the Directive in order to replace the reference to the Directive 85/611/EEC with a reference to the registration of the undertaking in any of the MS. However, the full set of collective investment schemes that could be usefully brought within the scope of the Directive needs to

be attentively identified and defined, and the practical consequences of such an extension examined.

As regards funds established outside the EU, it is at present not clear whether the term "undertakings for collective investment established outside the territory" encompasses all investment funds irrespective of the regulation applicable and of how they are placed to investors. An appropriate solution could be to refine this definition according to criteria which could be shared with countries outside the EU and which would ensure that interest income channelled through these vehicles is appropriately taken into account, irrespective of their geographic location. The existing OECD definition of “collective investment fund or scheme” seems a good basis for a possible amendment to Art. 6, as it includes any pooled investment vehicle, irrespective of legal form, and is simple and wide enough to minimize the risk of circumvention.

Some MS have called for a more radical extension of the scope of the Directive to any kind of investment income, but those views are currently not widely shared. For the reasons explained in the CSWD 559, this Directive may not be the most suitable framework for improving cooperation between tax authorities on payments of dividends and on capital gains from speculative financial instruments which do not provide substantial capital protection. Solutions based exclusively on exchange of information would also seem more appropriate for the purpose of ensuring that neither double taxation, nor avoidance of any taxation, arise in relation to life insurance contracts and pensions. However, until such purely information exchange solutions become fully operational between all MS, it could be worth considering transitional provisions extending the scope of the Directive at least to benefits from life insurance contracts providing no significant biometric risk coverage whose performance is strictly linked to income from debt claims or equivalent income covered by Art. 6 and which have characteristics (notably liquidity) allowing them to be marketed as substitute products to undertakings for collective investment.

3.4. Other refinements

There are also more procedural areas, where, on the basis of the experience, improvements to the Directive would be desirable for the sake of effectiveness. These relate to:

- the identification of beneficial owners (Art. 3);
- some procedural elements of the definition of interest payment (Art. 6);
- the information reporting by the paying agent (Art. 8);
- the exceptions to the withholding tax procedure (Art. 13), and
- some complements to Art. 18 (review) concerning statistics from Member States.

As regards Art. 3, three refinements seem advisable. The first would consist of ensuring a regular updating of the information on the permanent address of the beneficial owner for establishing his residence for the purposes of the Directive, by asking paying agents to refer to the “best information available to them at a payment date”. This would include information required for anti-money laundering purposes or other evidence to be agreed between MS through consultation procedures. Secondly, the paying agent could be obliged to replace this minimum "permanent address" approach with one based on official proof of tax residence in a specific country when such proof has been voluntarily provided by the beneficial owner to the paying agent, whether for the purposes of the Directive or for other purposes. A third refinement could consist of detailing the conditions under which paying agents request the beneficial owners' TIN, by annexing to the Directive a list of the MS which provide their resident individuals with a TIN and the official documents on which this TIN is mentioned (and the TIN format to prevent errors).

A procedural aspect of Art. 6 deserving consideration is how to create conditions for a reliable application of the *home country rule*. This is a necessary element for allowing paying agents to apply the Directive to income arising from undertakings for collective investment established in other countries. All the options adopted by a MS for its undertakings should be binding on the other MS. A range of acceptable criteria for the weighting of assets of the undertakings could be agreed in order to provide greater consistency. An agreed list of reliable data providers could be annexed to the Directive and a procedure for its updating provided. These data providers should notably be capable of ensuring the reliability of data for undertakings established outside the EU.

Two refinements seem advisable to Art. 8. First, in order to solve the current uncertainties concerning the treatment of joint accounts and shared beneficial ownership, the paying agents could be requested to provide some additional information on the features of the payment (whether the amount reported is the full amount, the actual share due to the beneficial owner or an equal share). Secondly, it would seem advisable to overcome the current limits of Art. 8(2), which do not oblige MS to distinguish between amounts referring to the interest element of a payment and those referring to the full proceeds from a sale, redemption or refund of debt claims or parts in UCITS. This lack of detail undermines the value of the information exchanged and increases the administrative burden for the State of residence of the beneficial owner in a way which is disproportionate to the burden on the paying agent and its State of establishment in providing the detail. It also makes it more difficult to measure the effectiveness of the Directive.

As to Art. 13, the Commission would suggest to the Council to examine if the procedure for exception to the withholding tax on the basis of a certificate submitted by the beneficial owner could be abolished. This procedure provides less detail to the State of residence of the beneficial owner and is less practical for the latter than the alternative procedure of voluntary disclosure and exchange of information. The additional burden put on the tax administration of the State of the paying agent by the compulsory application of this second procedure would seem justified. Moreover, the application of the certificate procedure can raise questions of compatibility with the free movement of capital, e.g. because it makes it difficult for an EU citizen who is tax resident outside the EU to avoid a withholding tax for which he cannot obtain a credit or reimbursement.

Finally, Art. 18 could be complemented by an obligation for MS to share between themselves and with the Commission in a timely manner some key statistics in order to allow a comprehensive measurement of the effectiveness of the Directive. This could be sustained by some additional but proportionate requirements on paying agents to contribute some more information to tax administrations (e.g.: number of beneficial owners subject to withholding tax under the Directive).