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EU Savings Directive

Background

The EU Savings Directive ("the Directive") is a measure designed to tackle tax evasion by individuals on cross-border payments of interest. The aim is to ensure that where an entity in one Member State pays interest to an individual who is tax resident in another Member State information is passed to the tax authority in the individual's Member State to enable the tax due there to be collected.

Timing

The draft Directive was adopted by the Council of Ministers on 3 June 2003 but it is due to come into force on 1 January 2005, although this is conditional on negotiations with certain non-EU countries (including Switzerland) and relevant dependent and associated territories.

Although the Directive comes into force on 1 January 2005, Member States must implement the Directive in their national legislation by 1 January 2004.

The Inland Revenue is currently consulting on the form of UK legislation.

Basic Framework

The Directive imposes an obligation on "**paying agents**" to collect information from **individuals** resident in another Member State to whom interest is paid. The paying agent then passes that information to its tax authority who in turn exchanges that information automatically with the tax authority in the Member State where the individual is resident.

The Directive applies to payments to an individual who is the **beneficial owner** of the interest. Interest payments made for the benefit of companies or other legal persons are excluded from the scope of the Directive.

"Paying Agent" is widely defined in the Directive, extended well beyond its normal meaning. The paying agent can be the debtor (or issuer), a collecting agent appointed by the individual, a paying agent appointed by the debtor or an investment fund. For an investment fund the paying agent will be the entity which makes the payment (e.g. a corporate Trustee).

The obligations under the Directive generally only apply to the **last** "paying agent" in a chain of intermediaries which makes the payment to the individual. If there are no intermediaries the debtor is the paying agent.

Definition of Interest

"Interest" is widely defined. It covers, interest on bank accounts, bonds and debentures and also discount and premia.

Interest on negotiable debt securities (e.g. bonds) issued before 1 March 2001 are excluded from the ambit of the Directive. This "grandfathering" applies during the transitional period (see below).

The definition of interest also includes certain payments by **investment funds** (UCITS and non-EU collective investment undertakings).

There are two types of payment covered:

1 Income distributions derived from interest payments ("look through").

In the UK this would cover distributions by Authorised Unit Trusts and Open Ended Investment Companies. The Directive allows Member States to opt to exclude investment funds with less than 15% of their assets invested in debt claims (for example equity funds). The UK Inland Revenue has indicated it will take up this option.

Where a fund exceeds the 15% test the UK rules are likely to provide that the **whole** of the distribution is reportable, not just the interest element.

2 Income received on the sale, refund or redemption of units or shares where the fund has more than 40% (25% from 2011) of its assets invested in debt claims ("roll-up").

There is an option in the Directive to restrict the reporting to the extent income derives from interest payments, but the UK Inland Revenue thinks this option may be impracticable

The Directive provides that the 15% and 40% tests can be worked out by looking at the composition of the fund's assets or by looking at the fund's investment policy as set out in its constitution or rules. The UK is likely to adopt the investment policy option.

'Grandfathered' debt instruments are not regarded as debt claims for the tests.

Funds themselves should have enough information to decide if the thresholds are met. Paying agents need to obtain this information from the fund. If the paying agent has no information it must report the income distribution or the whole redemption amount.

For roll-up funds the Directive gives the option to annualise rolled-up interest even if no sale, redemption or refund occurs in that period, but the UK will not be taking up this option.

Because of the options available for investment funds, fund operators may find that slightly different rules may apply from Member State to Member State.

Residual Entities

Although the Directive generally applies to payments to individuals there are special rules for "residual entities". These are entities which are neither legal persons, entities subject to business taxation nor a UCITS. The rules are designed to cover investment clubs. Payment of interest by paying agents to such entities must be reported and that information exchanged with the Member State of establishment of the residual entity. The residual entity is not required to comply with the provisions of the Directive when it makes a payment of interest.

Such entities can, however, opt to be treated as a UCITS, with the result that payments to the entity are not reportable, but payments by the entity, if made to individuals, are reportable.

Information Reporting

Where the Directive applies, the **paying agent** must report certain minimum information to its tax authority including:

- the identity and tax residence of the beneficial owner
- the name and address of the beneficial owner
- identification of the debt claim giving rise to the interest
- in the case of investment funds the amount of payments referred to in (1) and (2) above.

The Directive provides that Member States must introduce procedures which will enable the paying agent to identify the beneficial owners and their tax residence.

The identification rules mirror the money laundering 'know your customer' rules. However, the Directive makes a distinction between cases where "contractual relations" are entered into before 1 January 2004 and or after 1 January 2004.

Under the post 1 January 2004 the paying agent has to establish the payee's name, address, country of residence and their tax identification number (TIN) (or if there is no TIN the date and place of birth instead) and residence verified by reference to:

- the payees passport;
- information on any official identity card; or, if necessary,
- any documentary proof of identity presented by the beneficial owner.

Under the pre-1 January 2004 rules a reduced amount of information must be reported which the paying agent should verify from its existing records.

Transitional Period – Belgium, Luxembourg and Austria

For a transitional period Belgium, Luxembourg and Austria are not required to apply the information reporting rules in the Directive to paying agents in their jurisdiction. Instead, they must apply a withholding tax at the rate of 15% during the first three years of the transitional period, 20% for the subsequent three years and 35% thereafter.

The transitional period ends when agreement with specified third countries are concluded. The period is open-ended, but the rules are modified if the agreements are not concluded by the end of 2010.

The withholding tax must be applied to interest payments and the investment funds payments referred to in (1) and (2) above. Withholding tax can be avoided if the payee authorises the paying agent to report information instead.

The withholding tax revenues must be shared with the Member State of residence of the beneficial owner (in the proportions 25/75 per cent).

If a fund from another Member State or from outside the EU appoints a paying agent in one of these jurisdictions withholding tax may be due on fund distributions or redemptions.

Third countries and relevant dependent and associated territories

Negotiations are proceeding with specified third counties, such as Switzerland and the US, on the adoption of equivalent measures.

Dependent and associated territories which will be adopting equivalent measures include the Cayman Islands, BVI, Jersey, Guernsey and the Isle of Man.

There are indications that it is likely that Jersey, Guernsey and the Isle of Man will, like Belgium, Luxembourg and Austria adopt the withholding tax option rather than exchange of information. If they do, this may be a relevant consideration for investment funds appointing paying agents in those jurisdictions.

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