

# EU Savings Directive

An overview

### **Contributors**

This publication was written by Lynne Ed, Partner, Investment Management Tax Group and Michael Barnett, Director, Banking Tax Group, Ernst & Young, London.

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## Introduction

The Directive breaks new ground and will impact all global financial institutions. It involves a number of concepts that are peculiar to the EU, and also to the Directive. The Directive is concerned with tax, and in particular with the taxation of the ‘savings income’ of individuals.

## Purpose

The Directive’s stated aim is ‘to enable savings income in the form of interest payments made in one Member State to beneficial owners who are individuals resident for tax purposes in another Member State to be made subject to effective taxation in accordance with the laws of the latter Member State’. The Directive has the force of law and compliance with it is obligatory, but it only comes into practical effect in a Member State when that State has enacted its own domestic law to give effect to the requirements of the Directive.

## Timing and territorial scope

The Directive is now scheduled to take effect from 1 July 2005 in EU Member States. Several non-EU Member States (the ‘dependent territories’ and so-called ‘third countries’) have undertaken to adopt so-called ‘equivalent measures’. The affected countries are:

| EU Member States                    |                        |                |             |             |                      |                                      |
|-------------------------------------|------------------------|----------------|-------------|-------------|----------------------|--------------------------------------|
| Austria                             | Denmark                | Germany        | Italy       | Malta       | Slovak Republic      | Sweden                               |
| Belgium                             | Estonia                | Greece         | Latvia      | Netherlands | Slovenia             | United Kingdom (including Gibraltar) |
| Cyprus                              | Finland                | Hungary        | Lithuania   | Poland      | Spain                |                                      |
| Czech Republic                      | France                 | Ireland        | Luxembourg  | Portugal    |                      |                                      |
| Dependent Territories               |                        |                |             |             |                      |                                      |
| Anguilla                            | British Virgin Islands | Cayman Islands | Guernsey    | Jersey      | Netherlands Antilles | Turks and Caicos Islands             |
| Aruba                               |                        |                | Isle of Man | Monserrat   |                      |                                      |
| Countries adopting similar measures |                        |                |             |             |                      |                                      |
| Andorra                             | Liechtenstein          | Monaco         | San Marino  | Switzerland |                      |                                      |

## The broad concept

The basic mechanism is that a paying agent reports to his local tax authority payments of interest to individual investors, and that tax authority passes the information on to the country of residence of the individual. In some jurisdictions, due to bank secrecy concerns about information reporting, there will be a withholding tax instead of information reporting for a prolonged transitional period, but with an option for the investor to elect for reporting. In an attempt at anti-abuse, reporting is extended to payments to so-called “residual entities”, but in practice entities falling into this category are not expected to be numerous.

The Directive only applies to cross border payments, eg when a paying agent in a covered jurisdiction pays interest to an individual or residual entity in the EU, outside of the country where the paying agent is located. It doesn’t cover, say, a payment by a paying agent in Germany to a customer in Germany. In order to

avoid multiple reporting or withholding when there is a chain of paying agents, only the last paying agent in the chain is the paying agent for the purposes of the Directive.

### What is Interest?

‘Interest’ includes income from debt claims of any kind, including income from bank accounts, corporate and government bonds, debentures and other similar securities. The definition of interest is extended to include interest accrued or capitalized at the sale, refund or redemption of such debt claims, and original issue discount and redemption premiums. There are specific provisions to extend the definition of interest to distributions from and proceeds of sales or redemptions of collective investment schemes that hold interest-bearing investments above certain threshold percentages.

Note that the source of the interest is irrelevant – payment on US Treasury Bonds will be caught if the paying agent is in an affected territory.

### The paying agent

The key person in the Directive, on whom primary responsibility rests, is the paying agent. It is the paying agent who must report details of relevant payments to the local tax authority or apply withholding tax. Identifying who has the paying agent responsibility in the funds industry and outsourcing scenarios is particularly challenging.

### Documentation and reporting requirements

The Directive treats accounts established under so-called ‘contractual relations’ established before 1 January 2004 differently to those established after that date. For pre-1 January 2004 accounts reliance can be placed on customer documentation obtained under the KYC rules.

For accounts opened on or after 1 January 2004 the requirement is very specific and more complex, requiring establishment of the identity of the beneficial owner by reference to sight of the passport or other official identity card, and capture of the name, address and, if there is one, the Tax Identification Number (‘TIN’) allocated by the Member State of residence. If a TIN does not appear on the passport, official identity card, or any other document, the beneficial owner’s date and place of birth must be established by reference to the passport or official identity card.

There are specific additional provisions if the individual declares himself to be resident in a third country.

### Payments to entities

If a paying agent makes a payment to an entity, the latter is itself a ‘paying agent’ to which the reporting or withholding provisions of the Directive apply. There are, however, three important exceptions, these being ‘excluded entities’ that are defined as:

- a) legal persons (with a few specified exceptions), or
- b) entities whose profits are taxed under the general arrangements for business taxation, or
- c) entities that are recognised UCITS under the UCITS Directive.

An entity that qualifies as an excluded entity is also excluded from being a paying agent.

The phrase ‘residual entity’ is not one used in the Directive, but has gained widespread acceptance as meaning an entity that does not qualify as an excluded entity. Classification as a residual entity is usually reached by a process of elimination, and a survey by the European Banking Federation has shown a wide variation between countries – some have no residual entities, others regard trusts and partnerships as residual entities.

### Exemptions and derogations

The following is a general guideline in relation to exemptions provided under the Directive:

- Interest payments earned on certain bonds issued before March 2001 are excluded from the Directive until 31 December 2010 at the latest (this is to avoid triggering gross-up clauses in consequence of withholding under the Directive).
- Payments must be cross border from one State to another. Therefore, if the paying agent and the individual investor are resident in the same State, an exemption applies (but any normal domestic rules will apply).
- Interest payments are exempt if the recipient is another paying agent, a UCITS or an entity that has opted to be treated as a UCITS, because such recipients are within the scope of the Directive.
- Insurance and pension products are expressly excluded from the Directive.

## What could this mean for a global bank?

First, to the extent a bank has branches or subsidiaries in covered jurisdictions, it will have to identify the relevant businesses and operations where paying agent activity is taking place. This could include deposit-taking, custody, outsourcing, registrars and transfer agency, fund management and private client services.

The bank will have reporting or withholding responsibilities for EU individual customers (except 'same-country' customers), and it will need to get prescribed documentation about a customer's identity and certain other details, or for customers who are not individuals, documentation to prove that they are exempt from the Directive. (This documentation needs to be collected for new customers from 1 January 2004.) Then the bank will have to develop the systems necessary to identify the customers who are subject to reporting or withholding, identify the covered income, and perform reporting or withholding, as necessary.

Second, to the extent a bank's affiliates sponsor funds that are distributed in the EU, the bank has to determine

- a) whether the funds are covered by the Directive, and
- b) if so, whether payments made by the funds will be subject to the withholding regime or the reporting regime, and
- c) whether any restructuring is possible, or desirable, to escape the Directive, or, failing that, to move the paying agent function from one regime to another, and
- d) to the extent a fund is within the Directive, whether all the relevant service providers will be ready to do what needs to be done.

Third, a bank may have to consider customer relationship reconfigurations. Consider the hypothetical example of a German individual with an account at the Luxembourg private banking office. Luxembourg is a withholding jurisdiction, and so under the Directive, interest payments to the customer ordinarily would be subject to withholding with the option to agree to the exchange of information. Would the customer be better off/prefer to have his account in

- a) a withholding jurisdiction outside Germany, like Luxembourg,
- b) an information reporting jurisdiction outside Germany, like the Dublin private banking office,
- c) a private banking location in Germany, so that he would fall outside the Directive (but into German domestic law), or
- d) a location outside of Germany and outside of the Directive, like the Hong Kong office?

## Particular implications for investment funds

The Directive extends to investment funds (as defined) that own interest-bearing assets: in some cases, distributions paid by investment funds, and proceeds on sale or redemption of investment funds, are treated as interest income, and so subject to reporting or withholding. Non-distributing onshore and offshore funds that invest 40% or less in debt claims are excluded from the Directive. In addition, Member States have the option of excluding from the definition of savings income any income earned on investments in debt claims not exceeding 15% of the fund's assets where the fund is established in their home territory.

The Directive will have significant implications for the administration of both onshore and offshore investment funds. As one of the triggering events is the payment to an individual, any investment fund that makes payments through a particular paying agent to individual investors who are tax resident in the EU will be affected.

At investment fund level, the investment funds need to be categorized as being within or outside the scope of the Directive. Ongoing monitoring of what constitutes an interest payment needs to occur and exclusions that can be availed of need to be identified. The nature of the income stream may need to be analyzed (ie interest payments from underlying investments to the fund and then, most importantly, savings income from the fund to the EU individual investor). Account needs to be taken of the different requirements that may apply in each Member State.

Fund promoters, investment managers and directors should consider whether the investment objective and policy of the fund should include the 40% and 15% limits. Regard should also be had to the location of the fund's paying agent and of its investors and whether these investors are (i) individuals or corporates and (ii) EU residents.

## Summary

The aim of this publication is to give a high level overview of the Directive and its implications for global financial institutions. There are huge challenges for such institutions, not least how to manage a substantial cross-border, cross-discipline and multi-dimensional project that needs to be responsive to customer requirements for communication and product development, yet meet statutory obligations and maintain the bank's reputation. The project will have to be launched whilst the various revenue authorities are producing legislation and guidance and in the knowledge that there will be significant differences of interpretation between affected States. With a start date of 1 July 2005, time is short. As always, the devil will be in the detail, but the first step will usually be to map out the relevant products and identify where the relevant paying agents are located. From that point the project assumes dimensions of its own.

## Contact details

|  | Contact   | e-mail  |
|--|---|---|
| <b>EU Countries</b>  |   |   |
| <b>Austria</b>   | Christine Haidinger                                     | christine.haidinger@at.ey.com   |
| <b>Belgium</b>   | Koen Marsoul  | koen.marsoul@be.ey.com  |
| <b>Cyprus</b>  | Neophytos Neophytou                                     | neophytos.neophytou@cy.ey.com   |
| <b>Czech Republic</b>  | Rene Kulinsky   | rene.kulinsky@cz.ey.com   |
| <b>Denmark</b>   | Morten Sigetty  | morten.sigetty@dk.ey.com  |
| <b>Estonia</b>   | Tonis Jakob   | tonis.jakob@ee.ey.com   |
| <b>Finland</b>   | Marianne Malmgren<br>Hannele Liede                      | marianne.malmgren@fi.ey.com<br>hannele.liede@fi.ey.com                                |
| <b>France</b>  | Matthieu Dautriat<br>Carine Boffety Sabot               | matthieu.dautriat@fr.eylaw.com<br>carine.boffety.sabot@fr.eylaw.com                   |
| <b>Germany</b>   | Rosheen Dries   | rosheen.dries@de.ey.com   |
| <b>Greece</b>  | Maria Nikolopoulou<br>Mary Michalopoulou                | maria.nikolopoulou@gr.ey.com<br>mary.michalopoulou@gr.ey.com                          |
| <b>Hungary</b>   | Botond Rencz  | botond.rencz@hu.eyi.com   |
| <b>Ireland</b>   | Donal O'Sullivan  | donal.osullivan@ie.ey.com   |
| <b>Italy</b>   | Piera Vitali  | piera.vitali@it.eyi.com   |
| <b>Latvia</b>  | Egons Liepins   | egons.liepins@lv.ey.com   |
| <b>Lithuania</b>   | Kestutis Lisauskas                                      | Kestutis.Lisauskas@lt.ey.com  |
| <b>Luxembourg</b>  | Marc Schmitz  | marc.schmitz@lu.ey.com  |
| <b>Malta</b>   | Ronald Attard   | ronald.attard@mt.ey.com   |
| <b>Netherlands</b>   | Silvain Niekel  | silvain.niekel@nl.ey.com  |
| <b>Poland</b>  | Jaroslav Kozinski                                       | Jaroslav.Kozinski@pl.ey.com   |
| <b>Portugal</b>  | Mónica Santos Costa                                     | monica.costa@pt.ey.com  |
| <b>Slovak Republic</b>                                       | Tatiana Knoskova  | tatiana.knoskova@sk.ey.com  |
| <b>Slovenia</b>  | Magda Posavec   | magda.posavec@si.ey.com   |
| <b>Spain</b>   | Monserrat Turrado Alonso                                | monserrat.turradoalonso@es.ey.com   |
| <b>Sweden</b>  | Lars-Peter Ekelund                                      | lars-peter.ekelund@se.ey.com  |
| <b>UK</b>  | Michael Barnett<br>Kevin Charlton                       | mbarnett@uk.ey.com<br>kcharlton@uk.ey.com   |
| <b>Associated and Dependent Territories</b>                  |   |   |
| <b>Caribbean Region</b>                                      | Wade George   | wade.george@bb.eyi.com  |
| <b>Cayman Islands</b>  | Dan Scott   | dan.scott@ky.ey.com   |
| <b>Netherlands Antilles</b>                                  | Digna Van der Pol                                       | digna.van-der-pol@an.ey.com   |
| <b>Caribbean Territories<br/>(Anguilla, Montserrat, BVI)</b> | Ben Arrindell<br>Samantha Keeble-Carter<br>Connie Smith | ben.arrindell@bb.ey.com<br>samantha.keeble-carter@bb.ey.com<br>connie.smith@vg.ey.com |
| <b>Guernsey</b>  | Graham Parrott  | gparrott@uk.ey.com  |
| <b>Isle of Man</b>   | Jeremy Herridge   | jherridge@im.ey.com   |
| <b>Jersey</b>  | John Shenton  | jshenton@uk.ey.com  |
| <b>Third Countries</b>                                       |   |   |
| <b>Switzerland</b>   | Urs Kapalle<br>Bernhard Schopper<br>Hans-Joachim Jaeger | urs.kapalle@ch.ey.com<br>bernhard.schopper@ch.ey.com<br>hans-joachim.jaeger@ch.ey.com |

