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ЕУ ДИРЕКТИВА ЗА ОПОРЕЗИВАЊЕ ШТЕДЊЕ - РАЗВОЈ И ИЗАЗОВИ -[1]

***Апстракт*: *Директива 2003/48/ЕК којом је Европска Заједница покушала да координише политику држава чланица у области опорезивања прихода по основу камата на штедњу је од великог значаја за развој европског друштва. Сврха овог рада је да истражи и да прикаже нека решења Директиве. Прва део рада представља историјски преглед развоја Директиве са освртом на неке од најзначајнијих предлога Европске Комисије. Даље, други део рада описује систем који је успостављен тренутно важећом Директивом, са фокусом на циљ, поље примене, главне дефиниције као и два режима која Директива пружа. Коначно, у трећем делу настојимо да откријемо неке од недостатака и ограничења Директиве али и решења које су предложили званичници ЕУ. Упркос свом значају, Директива и даље има доста ограничења и правних празнина које омогућавају индивидуалним инвеститорима да заобиђу њену примену.*

Кључне речи: *Директива 2003/48/ЕК, Директива за опорезивање штедње, пореска координација, Рудингов извештај, ЕУ опорезивање штедње.*

1 Рад је резултат истраживања у оквиру пројекта „Заштите људских и мањинских права у европском правном простору“, бр. 179046 који спроводи Правни факултет у Нишу, а финансира Министарство просвете и науке Републике Србије.

I. TAX COORDINATION – BEHIND THE CURTAIN

The first section aims to present an overview of rationale for tax coordination in EU. Additionally, it will provide a historical overview of the development of Commission's viewpoints. In specific, the latter part of the section will present a transition between initial proposals, opting for withholding tax, 'coexistence' model, as well as the automatic exchange of information.

A. Tax coordination – why is it so important?

Capital income, and interest income from savings in particular, forms one of the most mobile tax base. Therefore, difference in taxation can cause distortions to capital allocation and flow. Indeed, investors, assessing overall investment conditions, will certainly take tax provisions into account when deciding how and where to allocate their capital.

In stable economies interest rates on savings tend to be low, just above the annual inflation rate.

This in particular is an incentive for investors to put their money "on the market", rather than keeping it "at home".

General economic principles suggest that an ideal economic environment is the one which does not influence stakeholders (i.e. investors and consumers) in making their choices. That way, it is argued, the allocation choices would be based on the exact needs of a market and the allocation would peak in its efficiency. In contrast, any sort of "artificial" influence on allocation leads to a distortion and ultimately to lower efficiency.

Related to EU taxation of savings, the ideal system would be the one which does not interfere with the optimal allocation of capital across countries. In other words, the system has to ensure that the post-tax marginal productivity of capital is equalized across countries in EU.[2] In order to achieve such system, it was necessary to implement some kind of coordination of savings taxation in the Union. Of course, the process of coordinating the governments is not an easy one. Member States tended to compete with each other, which ultimately leads to the "race to the bottom".

B. Historical development of Savings Directive

1. Withholding tax phase

In its communication to the Council from 23rd May 1989 Commission stressed that "full liberalization of the capital flow between Member States is going to be achieved through implementation of Council Directive 88/361 EC". Although this liberalization was considered to be a significant prerequisite for the genuine financial integration of the Community, it was hardly sufficient to achieve desired effects. Thus,

2 Patterson, B. and A. M. Serrano, *Tax co-ordination in the European Union.*Ed. Patterson B., 2001, p. 14

as found by Commission, it was necessary to take appropriate measures to remove, or at least reduce the tax obstacles which create problems on different levels.[3]

Nonetheless, the Commission also had to take into considerations the possible implications of any proposed measure. Thus, some of the following risks weighted against expected benefits were:

- the risk that savings will be shifted to banks and other financial institutions in third countries;
- the possible loss of business for Community banks and financial institutions.[4]

As found by the Commission in the aforementioned communication, merely measures taken on the national level would not be enough to mitigate distortions on the common market. Thus, certain level of coordination was proposed.

First of all, the Commission found the necessity of the common information system, in the meaning of the requirement of banks to disclose relevant information to the tax authorities. In fact, this was an early idea of the "exchange of information". However, at that stage such a measure clearly could not obtain necessary support. Apparently, it took around two decades before this measure was accepted as a main system, although still complemented by withholding taxes in some countries. In the same communication the Commission stressed that it realized the importance of bank secrecy, especially in those countries where it has a long tradition, however, the Commission encouraged all of the countries willing to participate in such a system to enter the adequate bilateral or multilateral agreements.

The second measure, expressly proposed by the Commission, was the common system of withholding tax on interests from personal savings. The tax rate proposed was 15%, which was considered to be an average at that point of time within the Community. Eurobond market was expressly excluded from the proposal. It was found that, in a case that Eurobond market were taxed, Community issuers of bonds would "move" to third countries, and issue bonds via their eventual subsidiaries in such countries. Furthermore, in the same case, nothing would stop the European investors from moving their assets elsewhere too.

Thirdly, the Commission stressed that any sort of restriction in communication between national tax authorities which stems solely from an administrative practice should be completely abolished. Furthermore, it has been realized that the Communities have to cooperate broadly on the international level, if they tend to eliminate the problem of tax evasion. Consequently the Commission stressed the importance of opening negotiations with the international community in order to tackle this issue.[5]

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3 Communication from the Commission to the Council No 89/60, 8th February 1989, *Proposal for a Council Directive on a common system of withholding tax on interest income*, 1989, p. 3

4 *Ibid. p. 3*

5 *Ibid. p. 3*

The Commission ultimately concluded its communication with two proposals. Namely, it proposed introducing a general withholding tax system, as well as more effective cooperation between national tax authorities, in order to fight tax evasion more efficiently. However, the proposal failed to acquire necessary support of the Council.

2. Rudding report

On the 25th October 1990 the Commission gave mandate to Mr. Onno Ruding to investigate the implications of tax divergence between Member States on the market of European Communities. The so-called "Rudding committee" was appointed to provide answers on the following questions:

a) Do differences among Member States cause major distortions in the internal market, particularly with respect to investment decision and competition?

b) In so far such distortion arise, are they likely to be eliminated through the interplay of market forces and tax competition between Member States, or is action at the Community level required?

c) What specific measures are required at the Community level to remove or mitigate these distortions?[6]

It should be noted that the Committee found principal differences in the area of tax treatment of cross-border income flows. According to the notion of the Committee, these differences were, among the others, main reasons for bias against inward and outward direct investments.

The empirical survey of the Committee provided significant evidence of allocation distortion, as a direct consequence of taxation inconsistency. The difference, it was proved, influenced the investment decisions of large multinational corporations at the appreciable level, thus, creating distortions in competition in the financial sector of the Community. Even though the evidence was strong enough to generally prove high scale of the distortions, it was not possible to quantify with appreciable certainty its impact on investment decisions[7].

Even though it has been observed that Member States converged to some extent respective tax systems by means of unilateral measures, the wide differences in tax regimes were still remaining at the time in question. In addition, the Committee found it unlikely that the divergence would be repealed by merely unilateral action. Therefore, the conclusion was drawn in favor of coordinated action on a Community level. However, in considering what measures to recommend, the Committee have taken into consideration all of the factors which, at the time being, argued in favor of

6 EC - Commission, *Conclusions and recommendations of the Committee of Independent Experts on Company Taxation,* Ed. Luxembourg: Office for Official Publications of the European Communities, 1992, p. 9

7 *Ibid. p. 5*

limiting harmonization to a minimum necessary to remove distortions. In particular, some of the considered factors were as follows:

- the fact that national governments of Member States wished to retain power and flexibility over direct taxation as much as possible;
- the principles of proportionality and subsidiarity;
- the need for unanimity on tax matters.

Consequently, the Committee proposed immediate adoption of the draft directive which would aim at abolishing withholding taxes on interests. Moreover, the directive, in the Committee's view, should apply to all such payments between enterprises within the Community.[8]

3. "Coexistence" phase

The Commission's proposal for adopting a directive which would introduce common withholding tax system on a Community level failed to reach unanimity before the Council. Therefore, the proposal has been withdrawn and, at the same time, a new proposal has been presented.

The new proposal basically introduces a concept which differs from the previous; a "Coexistence model". Coexistence principle would allow Member States to, when implementing the directive, freely choose between two principal options. Namely, Each Member State would either apply a withholding tax, or provide critical information about the income from savings to other Member States. The advantage of Coexistence model, as seen by Commission at the time being, was the possibility for Member States to remain flexible and free to choose the most suitable measure, even though the spectrum of options was limited. [9]

Additionally, it should be noted that even Member States which would adopt withholding tax method would still be encouraged to implement information exchange measures. Moreover, it seems that the information exchange system was preferred, even though it was likely to expect the resistance of some of the Member States.

Throughout the years, the idea of information exchange have been evolving, and with a good reason. Among other factors, it seems that information exchange system reconciles two opposed aspirations, i.e. source-based taxes and residence-based taxes. Due to quite obvious reasons, every Member State aspires to have as wide tax base as possible, which consequently leads to residence-based taxes. However, from the administrative and cost-benefit point of view, source-based taxes are much easier to implement, therefore, less costly than former, but those taxes do not generate revenue for capital-exporting countries. Information exchange system lowers the administrati-

8 *Ibid. p. 5*

9 Communication from the Commission to the Council No 98/295, 20th May 1998, *Proposal to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community*, 1998, p. 3

ve cost for capital-exporting Member States to tax income accrued in other Member States, as opposed to the withholding tax system.

The scope of the directive has been limited to interest paid in each Member State to individual residents in another Member State. This scope covers all cross-border payments of interest to individuals within Community.

As regards to the tax rate, it was noted that a balance had to be found. Commission feared that, in a case of a tax rate set to high, the capital would move out of Community with a rapid pace. From the other hand, too low withholding tax rate might stimulate individuals not to declare their income which originates from a cross-border interest payment. This way, their income would be subject only to a withholding tax which rate might be much lower than in their country of residence.

Finally, it was decided that a balanced tax rate should amount to 20%, with a possibility of avoiding such taxation. Namely, in a case that an individual would prefer its interest income to be taxed in the Member State of residence, it would merely need to present a certificate that it has declared the interest payment as its income for the purposes of taxation in the Member State of residence.[10]

The final novelty of the proposal from 1998 was an official recognition of a necessity to spread the basic principles of the directive as wide as possible. In order to preserve the competitiveness of European financial markets, it would be mandatory to negotiate the application of the basic principles by the main third country commercial partners. Moreover, Member States with dependent territories would have to ensure the equivocal application of the directive in those territories, due to the same aforementioned reasons.

4. Shift of paradigm – information exchange

The Commission's proposal from year 2001 essentially differentiated from its ancestor from 1998. Namely, the former proposal was based on the Coexistence principle. However, the proposal failed to achieve required unanimity in the Council. Consequently, the former proposal was withdrawn, and at the same time a new one has been presented.

During the preparatory consultations and meetings it was realized that, in order to prevent erosion of a tax base, it would be mandatory to spread the application of core principles outside of Community.

Therefore, it was agreed that as soon as the Council had reached the agreement on the substantial level of the Directive (and even before its adoption) the Presidency and the Commission would immediately start negotiations with the US and key third countries (Switzerland, Liechtenstein, Monaco, Andorra and San Marino) to promote the adoption of equivalent measures in those countries. Apart from the third countries, Member States with dependent territories expressed a will to promote the adoption of the same measures in those countries.

10 *Ibid. p. 7*

As a result of a European Council meeting on 19-20th June 2000, Member States have reached a consensus about information exchange system, as an ultimate goal of European Union. Additionally, Member States agreed that only a limited number of Member States would apply a transitional withholding tax, and only for a limited time period. The Member States in question agreed to shift to exchange of information, as soon as certain conditions are met, however, not later than seven years after entry into force of the directive.[11] Member States which apply withholding tax are obliged to transfer 75% of the revenue collected to the Member States of residence of the investor.

Austria, Belgium and Luxemburg are no exceptions from information exchange by a mere chance. Those three countries with a strong banking secrecy tradition strongly opposed to the idea of sharing relevant information. In order to preserve the proposal, Commission had to allow Austria, Luxembourg and Belgium to apply a withholding tax (initially at 15%, now 20% and rising to 35% in 2011).[12]

II. DIRECTIVE AT A GLANCE

In the following section I will provide a general insight into the Directive, in particular, goal of the directive, scope of application, as well as the main definitions.

A. Aim of the directive

As stipulated in the recitals of the Directive, in the absence of any coordination of taxation of cross-border interest payments, individual residents of Member States are certainly in a position to avoid any taxation of such an income. In principle, there should be no need for a Directive on personal savings income. A taxpayer in one Member State who receives interest from some asset in another Member State is already required to declare such an income to national tax authorities. In practice, it is quite enough for an individual resident to merely fail to declare the income, and the lack of information would prevent tax authorities of Member State of residence to apply appropriate tax. As well observed by the Rudding Report: "the free movement of capital... together with the existence of bank secrecy... will increase potential for tax evasion by individuals."

The directive aims to enable savings income in the form of cross-border interest payments to be made subject to effective taxation. The cross-border element means that the interest, based on a debt claim, arises, becomes effective and it is paid by a paying/economic agent in one Member State to the beneficial owners resident in

11 Communication from the Commission to the Council No 2001/0164, 18h July 2001, *Proposal to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community*, 2001, p. 2

12 Investors Offshore, "The EU Savings Tax Directive", http://www.investorsoffshore.com/html/specials/012011_eu_savings_tax_directive.html

another Member State.[13] By applying effective taxation, the directive aims to remove potential for distortion of Community's internal market.

B. Scope of the Directive

Article 1 of the directive roughly sets out material scope of application. By stipulating the aim of the Directive, it provides that the Directive would apply in cases of a cross-border interest payment.

However, Personal scope of the Directive limits its application only to such payments made to individual investors, i.e. natural persons. Nonetheless, this Directive imposes certain obligations to paying agents as well, thus including them into personal scope of application.

As for the territorial scope, it is worth noting that Commission was eager to extend application of the Directive not only to all of the Member States, but also to dependent Member States territories as well as other jurisdictions. The "exporting" of the Directive, though clearly justified, evidently contrasts other pieces of Community legislation, which, in some cases, do not even apply to all of the Member States. Therefore, the Directive applies in:

- all EU member states;
- dependent or associated territories of EU member states, being Anguilla, Aruba, British Virgin Islands, Cayman Islands, Gibraltar, Guernsey, Jersey, Isle of Man, Montserrat, Netherland, Antilles, and the Turks and Caicos Islands;
- other jurisdictions that have agreed to participate are Andorra, Liechtenstein, Monaco, San Marino and Switzerland;
- Singapore, Hong Kong, Macao, Bermuda and Barbados have been asked to participate and have so far declined.

Temporal scope, however, is determined by entry into force of the Directive, and it applies to all interest payments made after its entry into force, with one significant exception ('grandfathering' bonds). The Directive was approved in 2003. and it entered into force on the July 1st 2005.

C. Definitions

The Directive provides definitions of beneficial owner (Art. 2), of paying agent (Art. 4), of competent authority (Art. 5), of interest payment (Art. 6).

1. Beneficial owner

Beneficial owner is an individual who receives an interest payment, or for whom the interest payment is being secured, unless she/he provides evidence that it was not received nor secured for hers/his own benefit. In other words, beneficial owner is a

13 Directive 2003/48/EC from the Council, of 3rd June 2003, on taxation of savings income in the form of interest payments, Official Journal of the European Union no. L 157/48, of 26th of June 2003, p. 39

natural person as well as the last link in the chain of interest payment. Conversely, if a natural person receives an interest payment but merely as an intermediary, she/he will be regarded to be a paying agent, but not a beneficial owner.

Moreover, the cross-border element must be fulfilled. Consequently, the Directive applies to any individual who is resident in one EU country who has interest paid to or secured for them in another EU country or participating state.

It should be noted that the crucial criterion for application of the Directive is residence. Namely, the Directive does not apply to persons resident outside the Member States or the Crown Dependencies of the UK. In other words, EU nationality does not have any significance for application of the Directive, therefore, even EU Nationals would be out of the scope of application in a case they are not residents of any of the Member States or the dependent territories. Finally, any new countries joining the EU will be obliged to apply the Directive, thus their residents will be under the scope of the Directive as soon as those countries accede the EU.[14]

2. Paying Agent

The Directive defines ‘paying agent’ as any economic operator who pays interest to or secures the payment of interest for the immediate benefit of a beneficial owner. It is irrelevant if an economic operator is a legal or natural person. Furthermore, it is of no significance if an economic operator is a debtor of the debt claim or merely charged by the debtor or the beneficial owner in questions.

There are a few good reasons to separate the function of paying agent and the attribute of a debtor. For starters, the Commission aimed to widen the scope of application of the Directive. Namely, this particular solution (i.e. separation of functions) provides for the applicability of the Directive in such situations where the debtor is located outside of the Community. For example, if a debtor, resident outside of EU, charges an economic operator, resident of a Member State A, to act as an intermediary for the purpose of the payment of the main debt and/or interest to an individual investor who is resident of a Member State B, the economic operator in question would be deemed to be a paying agent for the purposes of this Directive. Practically speaking, the economic operator would be obliged to apply the Directive which imposes upon the paying agent some obligations. Another reason for this division of function is certainly the administrative costs which have to be borne by a paying agent. Indeed, it would be irrational to expect from merely any debtor to be obliged and able to apply provisions of the directive. Would that be a case, investors would have an additional burden, which, on the long run, might lower incentives for investment at a certain extent. Conversely, the paying agent can check, using simple procedures and at little

14 *Op.cit.*

cost, whether the interest is paid to an individual, and to request a proof of residence for tax purposes. [15]

In order for an economic operator to be qualified as a paying agent it is necessary that the economic operator represents the last link in the payment chain before the relevant payee or residual entity. It should be noted, however, that economic operators which are included in the in the payment process are not regarded as effecting the payment if their role is merely passive, or auxiliary. The former situation is possible in a case where an economic operator acts on instructions from others, whereas the latter exists in a case that economic operator provides services in order to assist the paying agent. For example, a bank does not make a payment by merely issuing or sending a cheque, or arranging for the electronic transfer of funds on behalf of one of its customers.[16]

The qualification of a paying agent is important due to the obligations that the Directive imposes on it. Namely, the paying agent is in any case obliged to collect at least some minimum information, as provided by Art. 8. In addition, the paying agent might be obliged to either disclose relevant information to competent tax authorities or apply a withholding tax, depending on the system which a Member State of residence of the paying agent applies. If a paying agent is located in Austria, Belgium or Luxemburg, it would be obliged to apply withholding tax, unless the beneficial owner authorizes the agent to disclose relevant information to competent authorities. Likewise, if a beneficial owner provides a certificate, issued by tax authorities of Member State of its residence, which proves that it has declared the interest in question as a taxable income, paying agent would not apply withholding tax.

3. Interest payment

The Directive defines interest as "interest paid or credited to an account, relating to debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and, in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures; penalty charges for late payments shall not be regarded as interest payments." This definition corresponds to the OECD definition of interest. However, the Directive adds three more categories to the OEC definition and is therefore somewhat broader than the international definition of interest payments.[17]

15 Communication from the Commission to the Council No 98/295, 20th May 1998, *Proposal to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community*, 1998, p. 4

16 *Op.cit.*

17 Hemmelgarn, Thomas and Nicodeme, Gaetan, *Tax Co-Ordination in Europe: Assessing the First Years of the EUSavings Taxation Directive* (June 2009). CESifo Working Paper Series No. 2675. Available at SSRN:http://ssrn.com/abstract=1434293

There are four main categories of savings income under the scheme:

- interest paid out on debt-claims or credited to accounts;

- interest rolled-up and paid out when a debt-claim is repaid or sold;

- distributions made by certain unit trusts and other collective investment funds which have invested more than 15% of their investments in debt-claims;

- accumulated income paid out when units in certain collective investment funds that have invested more than 40% of their investments in debt-claims are redeemed or sold.

Most other types of income (for example, dividends on ordinary or preference shares of companies, salary and pension payments) fall outside the definition and are therefore outside the scope of the STD. Some specific types of payment which do not qualify are as follows:

- payments under contracts for differences;

- manufactured payments arising during stock loans or under sale and repurchase agreements(including where the underlying security is a money debt);

- debts which do not arise from a transaction for the lending of money (for instance where there is a late payment and compensation interest is paid);

- 'Grandfathered bonds'. Certain negotiable debt securities are not treated as money debts if they meet certain conditions for the duration of a transitional period which will end no later than 31st December 2010. These securities ("grandfathered bonds") do not then count as money debts for all purposes of the regulations: interest, premiums and discounts derived from these bonds are not savings income; and investment in these bonds does not count when deciding whether the thresholds which determine whether income from certain collective investment funds is savings income have been passed. A security is a grandfathered bond if it was first issued before 1 March 2001 or the prospectus was first approved by the appropriate regulatory authority before that date, and no further issue was made on or after 1 March 2002. If the bond is a government bond (or issued by a related public authority or an international organization and a further issue is made on or after 1 March 2002, the whole of the issue (whether made before, on or after 1 March 2002) is not a grandfathered bond. The whole issue of the bond is a money debt. If the bond is issued by another type of issuer (e.g. a commercial company) and a further issue is made on or after 1 March 2002, only the part of the issue made on or after 1st March 2002 is not a grandfathered bond. This part of the bond issue is treated as a money debt; the rest of the issue (made before 1 March 2002) is not a money debt;

- distributions and other payments derived from funds which are not UCITS or elective UCITS are not reportable as savings income under the regulations. A UCITS is an 'undertaking for collective investment in transferable securities' authorized in accordance with the UCITS Directive. Non-EU funds may or may not be UCITS depending in a complex way on their nature. Even when a fund is a UCITS,

its distributions are only taxable under the STD when the 15% threshold for income from money debts is breached.[18]

4. Competent authority

Competent authorities are tax authorities of concerned Member States of residence of both beneficial owner and a paying agent.

D. The two regimes of the Directive

The countries or territories applying the Directive apply one of the two regimes, an information exchange regime, or a withholding tax regime. However, in a case of some countries applying withholding tax, the beneficial owner may opt for information exchange. In this way, the beneficial owner would avoid taxation in accordance with rules of the Member State where she/he is not resident.

However, it seems that this possibility of choice for a beneficial owner is more apparent than real in most cases, since it depends on the willingness of a financial institution to provide for such a choice, and many banks may not wish to have an additional administrative work than necessary to implement information exchange.

1. Information exchange

When the Commission started proposing the initial versions of the Directive, information exchange have been viewed as hypothetic, yet not quite probable solution for tax coordination. Initially, withholding tax was a more favorable option, even though early versions of the Directive failed to acquire unanimous support in the Council. Over time, the position of the Commission had changed, thus there was a phase where both solutions were regarded as equally desirable ('coexistence' model).

The latest developments, as well as the current version of the Directive, clearly indicate that withholding tax is but a transitory solution, whereas information exchange is an ultimate goal of the Union in the area of savings taxation.

Over the past decade, the opportunities to evade taxes on foreign income have increased dramatically. One particular problem is that the existence of a bank account in country B owned by a resident of country A is usually not known by the tax authority of country A. This leaves it entirely in the control of the individual to decide whether she/he wants to report the income paid on this account in her/his annual tax return. As a result the temptation to use offshore secrecy jurisdictions to evade tax has been substantially increased. The price of tax evasion is paid by honest tax payers and citizens with low incomes, who do not have the possibility to accumulate savings outside their home country.

Automatic tax information exchange aims to rectify this situation by requiring country B's bank to report to its tax authority the interest paid on the account of the citizen of country A, and in a second step to transfer this information to the tax aut-

18 *Op.cit.*

hority of country A. This information can then be checked for accuracy against the tax return submitted by the taxpayer.[19]

The majority of Member States prefer information exchange disclosure. In specific, this system enables them to tax the interest payments accordingly to their self-determined tax rates. In addition, the information collected in a such way might also be used to track the origin of the capital, to combat money laundry, as well as for other similar purposes.

Information exchange scheme works in a simple way; after the maturity period the paying agent pays the gross amount of interest to the beneficial owner (no tax deducted). In return, the paying agent requires beneficial owner to provide sufficient information, in compliance with the provisions of the Directive. Paying agent then discloses relevant information to the competent authorities of its own Member State of residence, whereas the latter contacts and transposes this information to the tax authorities of the Member State where beneficial owner is resident for tax purposes. The latter tax authorities are supplied with sufficient information, thus are able to apply national tax rates.[20] The information has to be provided automatically at least once a year and within six months after the end of the fiscal year of the Member State of the paying agent.

As indicated earlier, Austria, Belgium and Luxembourg did not agree to reveal information until USA and Switzerland conform. As a result, till this time, they will get information from the other twelve Member States, but they themselves will apply a special withholding tax under this directive.

2. Withholding tax

Under the withholding tax scheme, paying agents automatically deduct tax from interest and pass it to their local tax authority. According to the Directive, the local tax authority is entitled to keep 25%of the total amount collected, and remits the remaining 75% to tax authorities of beneficial owner's Member State of residence. The receiving country gets a bulk payment, without any information about the individuals covered and taxed under the Directive. The rates of withholding tax are 15% from July2005, 20% from 1st July 2008, and 35% from July 2011.

In the three Member States which will apply a withholding tax, the Directive specifies that they also need to provide one or both of the following procedures in order to ensure that a relevant payee may request that no tax be withheld:

- a procedure which allows the relevant payee expressly to authorize a paying agent to report information to his Member State of residence; and/or

19 Meinzer M., *Briefing paper on EU-savings tax directive and automatic tax information exchange*, www.taxjustice.net/cms/upload/pdf/EUSTD-TJN-Briefing_-_JAN-2011.pdf

20 Ashta, Arvind, *The EU Savings Directive (ESD): Taxation of Savings Income in the Form of Interest Payments* (2003/48/EC, June 2003) (January 31, 2007). Available at SSRN: http://ssrn.com/abstract=1293191

- a procedure which ensures that withholding tax is not levied where a relevant payee presents to his paying agent a certificate drawn in the name of a competent authority of his Member State of residence.[21]

These two options are significantly different. The first option ensures that the correct tax should be paid by the resident of a country in that country. The second option ensures only that a withholding tax is paid, which is likely to be lower than the full liability due in the recipient's country of residence.

In addition, part of the benefit also goes to the country where the account is held, rather than that in which the recipient resides. For these reasons, the second option is not an effective measure to stop tax evasion, and has only been accepted as a temporary measure by the EU, which does eventually need to eliminate this option if the prevention of tax evasion is its objective.

III. CHALLENGES AND SOLUTIONS

This final section will present some of the current problems of the directive, as seen by some of the experts from this field. In addition, II shall reflect upon some of the officially proposed solutions, aimed to deal with the limitations.

A. Problems with the Directive

The directive is a result of long lasting negotiations. Being so, it was bound to have some limitations as a result of a political compromise between Member States. The directive's current limitations are fourfold.

Firstly, only interest payments are covered, leaving out dividends and royalties. The most obvious target investments for EU residents, after adoption of the Directive, are 'grandfathered bonds', excluded investment funds (i.e. not caught by the 15% or 40% debt thresholds), various types of offshore life assurance-based product, and equities or their derivatives. In specific, Tina Klautke and Alfons J. Weichenrieder concluded:

"...the directive has left one explicit loophole by providing grandfathering (exemption from withholding tax) for some securities. In this paper we have compared the pre-tax returns of these exempt bonds and comparable taxable bonds. If working around the Savings Directive is difficult for tax evaders in Europe, then investors should be willing to pay a premium for bonds that are exempt from the withholding rate. Conversely, if such a premium is absent, then we may conclude that the supply of existing loopholes (exempt bonds included)is large enough to allow tax evaders to continue evasion at negligible additional cost. The findings of our study are in line with this latter interpretation. This suggests that, at least so far, the Savings Directive is only a minor hassle for European savers looking for ways to work around interest income taxation. This stands in striking contrast to the considerable bureaucratic and political efforts that have been exerted to introduce the measures taken. As a caveat,

21 *Op.cit.*

it should be noted that grandfathering will end at December 31st, 2010. At least, this will close the loophole that has acted as a litmus test in the present study."[22]

Second, only payments to individuals (or natural persons) are covered. Legal entities whose profits are taxed under the general arrangements for business taxation and similar entities (e.g. companies, partnerships and limited partnerships) are not relevant payees and payments to such persons fall outside the scope of the Directive. Trusts and foundations are equally exempt in most territories.

Third, it is limited geographically to the EU, although equivalent measures have been established in separate treaties (multilateral or bilateral) with 15 additional jurisdictions enjoying close ties to the EU. These additional jurisdictions aer comprised of five third countries (Andorra, Liechtenstein, Monaco, San Marino, Switzerland) and ten dependent and associated territories (Aruba, Anguilla, Guernsey, Jersey, the Isle of Man, Cayman Islands, British Virgin Islands, Netherland Antilles, Montserrat, Turks and Caicos Islands). It is therefore clear that investors will still be able to evade taxes by shifting their funds to banks and other intermediaries located in tax havens and financial centers that do not fall under the scope of the directive and its related agreements. Hence, these jurisdictions do not ensure either a minimum level of taxation or an exchange of information on income paid to nonresidents.

The most frequently-mentioned examples are Hong Kong, Dubai, Panama, Singapore, and Macao. Tax evasion by using financial intermediaries that reside in these countries can be relatively easy.[23]

Fourth, Luxembourg and Austria negotiated a transitional exclusion from the automatic information exchange process by substituting a withholding tax of currently 20% (from July 2011 it will be 35%) on the interest payments to the concerned nonresidents. They share the revenue with the country of residence of the account holder, with the latter receiving 75 percent of the total. The same withholding tax provision has been agreed with eleven of the 15 non-EU jurisdictions, including Switzerland, though this agreement is not considered transitional.

Consequently, by using these loopholes, the Directive may be circumvented by:

- placing the funds on deposit in the name of a company with a limited liability;

- by transferring the sums on deposit into a trust or foundation. In these arrangements the funds on deposit are usually held by professional nominees on behalf of the beneficial owners. These arrangements are not covered by the Directive;

- moving the investment out of cash and into any other form of investment e.g. shares;

- putting the investment into an insurance "coat" or "wrapper";

22 Klautke, Tina and Weichenrieder, Alfons J., *Interest Income Tax Evasion, the EU Savings Directive, and Capital Market*

23 Hemmelgarn, Thomas and Nicodeme, Gaetan, *Tax Co-Ordination in Europe: Assessing the First Years of the EU Savings Taxation Directive* (June 2009). CESifo Working Paper Series No. 2675. Available at SSRN: http://ssrn.com/abstract=1434293

- moving the sum deposited to a non-participating location such as, for instance, Singapore or Dubai.[24]

B. The Savings Directive in perspective

A review of the directive in 2008 highlighted the weaknesses, revealing changes in the pattern of investments in response to the directive. There was a relative flight away from debt securities (interest bearing instruments, such as bonds, obligations) towards equity securities (shares, stock). This switch was probably at least partly motivated by attempts to avoid the directive.24 The second observable reaction was a geographical displacement of funds to jurisdictions beyond the scope of the directive. In reaction to this, a proposal for a revised directive was submitted by the European Commission to the EU-Council in November 2009. This proposal addresses two out of the four limitations, those relating to legal entities and those relating to geographical scope.

Namely, as noted by the EU Council, the Directive 2003/48/EC has proven effective during its first three years of application, within the limits set by its scope. However, it appears from the first Commission report on its application that it does not fully measure up to the ambitions expressed in the conclusions adopted by the Council in 2000. In particular, certain financial instruments which are equivalent to interest-bearing securities and certain indirect means of holding interest-bearing securities are not covered.

Finally, it should be noted that there is a political will to bring the changes into the current Directive. Some of the proposed changes are as follows:

- introduction of "look-through" approach:

"...directive 2003/48/EC applies only to interest payments made for the immediate benefit of individuals resident in the European Union. These individuals may thus circumvent Directive2003/48/EC by using an interposed entity or legal arrangement, especially one established in a jurisdiction where taxation of income paid to this entity or arrangement is not ensured. Having regard also to the anti-money laundering measures laid down in 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 financing6, it is therefore appropriate to require paying agents to apply a "look-through approach" to payments made to certain entities or legal arrangements established or having their place of effective management in certain countries or territories where the Directive or measures to the same or equivalent effect do not apply. They should use the information already available to them about the actual beneficial owner(s) of such entities or legal arrangements to ensure that the provisions of Directive 2003/48/EC are applied when the beneficial owner so identified is an individual resident in a Member State other than the one where the paying agent is established. In order to reduce the administrative

24 Council of the EU, Inter-institutional file No: 2008/0215, 25th November 2009, Brussels, p. 4

burden on paying agents, an indicative list of entities and legal arrangements in third country jurisdictions concerned by this measure should be drawn up.";

- widening the concept of a paying agent:

"...circumvention of Directive 2003/48/EC through artificial channeling of an interest payment via an economic operator established outside the European Union should also be avoided. It is therefore necessary to specify the responsibilities of economic operators when they are aware that an interest payment made to an operator established outside the territorial scope of Directive 2003/48/EC is made for the benefit of an individual, known by them to be a resident of another Member State and who can be considered to be their customer. In such circumstances, those economic operators should be considered to be acting as paying agents. This would also in particular help to prevent a possible misuse of the international network of financial institutions (branches, subsidiaries, associated or holding companies) to circumvent Directive 2003/48/EC.";

- widening and clarifying the concept of interest payment:

"...it appears from the first report on the application of Directive 2003/48/EC that it may be circumvented by the use of financial instruments which, having regard to the level of risk, flexibility and agreed return, are equivalent to debt claims. It is therefore necessary to ensure that it covers not only interest but other substantially equivalent income. Similarly, life insurance contracts containing a guarantee of income return or the performance of which is at more than 40% linked to income from debt claims or equivalent income covered by Directive 2003/48/EC should be included in the scope of this Directive. The definition of interest payment should be clarified to ensure that not only direct investments in debt claims but also indirect investments are taken into account in the calculation of the percentage of the assets invested in such instruments. Furthermore, in order to facilitate the application by paying agents of Directive 2003/48/EC to income arising from undertakings for collective investment established in other countries, it should be made clear that the calculation of the composition of the assets for the treatment of certain income of such undertakings is governed by the rules laid down in the Member State of the European Union or of the European Economic Area in which they are established.";

- proposals regarding investment funds:

"...as regards investment funds established in the European Union, Directive 2003/48/EC at present covers only income obtained through undertakings for collective investment in transferable securities authorized in accordance with Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)7. Equivalent income from non-UCITS falls within the scope of Directive 2003/48/EC only when non-UCITS are entities without legal personality and therefore act as paying agents on receipt of interest payments. In order to ensure the application of the same rules to all investment funds or schemes independently of their legal form, the reference in Directive 2003/48/EC to Directive 85/611/EEC should be replaced with a reference to their registration in accordance with the law of a Member State or their fund rules or instruments of incorporation being governed by the law of one of the Member States. Furthermore, equal treatment should be ensured taking into account the Treaty on the European Economic Area. As regards investment funds not established in a Member State of the European Union or of the European Economic Area, it is necessary to make clear that the Directive encompasses interest and equivalent income from all those funds, irrespective of their legal form and of how they are placed with investors."[25]

25 Council of the EU, Inter-institutional file No: 2008/0215, 25th November 2009, Brussels, page 6.

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EU SAVINGS TAX DIRECTIVE - DEVELOPMENT AND CHALLENGES –

Summary

Council Directive 2003/48/EC has been very significant for the European society, due to various reasons. One of them is certainly the fact that the Directive has been a major political break-through in the development of the Communities and the EU. Merely one decade ago the idea of abandoning the concept of banking secrecy was completely unthinkable, whereas today there is at least a vision of information circulation, for the purpose of combating tax avoidance. Additionally, the Directive has established a system of coordination between tax authorities of the Member States.

The importance of the Directive as well as of the matter it regulates is clearly demonstrated by the EU efforts made in order to introduce the application of this Directive in other jurisdictions.

However, it would be much more difficult from the political point of view to achieve that goal. Despite its significance, the Directive still has many limitations and loopholes which make possible for individual investors to circumvent its application. Some of the difficulties have been listed in one of the sections.

Finally, the possible solutions in order to remove the limitations are not so difficult to find.

However, the implementation of those solutions depends at a high level on the political will not only of the EU but also of other jurisdictions, relevant for the achievement of the desired effects of the Directive. The time will have to show how successful prospect negotiations are going to be in overcoming the differences between EU and its significant political partners.

Key words: *Council Directive 2003/48/EC, Savings Taxation Directive, Tax coordination, Rudding report, EU Savings taxation.*