Proposed amendments to the European Savings Taxation Directive

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PRICEWATERHOUSECOOPERS

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The proposed amendments are likely to affect certain products sold by wealth managers.

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The European Commission adopted an amending proposal to the European Savings Taxation Directive (EUSD) on 13 November 2008. The Commission noted that the proposal seeks to ensure the taxation of interest payments which are channelled through intermediate tax-exempted structures. It is also proposing to extend the scope of the Directive to include income equivalent to interest obtained through investments in some innovative financial products, as well as in certain life insurance products.

This article summarises the scope of the existing EUSD, as well as considering the impact of the proposed changes for the wealth management industry.

What does the existing EUSD do?

The Directive was introduced as an anti-tax evasion measure to stop individuals resident in one member state from putting savings into investments in other member states, collecting the interest and not declaring this as taxable income in their home state. The European Union (EU) also concluded bilateral agreements, equivalent to the regulations of the Directive, with third-party states (e.g. Andorra, Liechtenstein, Monaco and Switzerland).

The existing Directive and the bilateral agreements with third-party states cover 'interest payments' made to individuals. The term 'interest payment' is defined in the Directive and the agreements and is fairly widely drawn to include income from bank savings accounts, as well as bonds, debentures producing an interest-like return and also collective investments that produce an interest-like return.

What are the proposed changes and how would they affect the wealth management industry?

The European Commission noted that based on an analysis of the functioning of the Directive, the regulations have proven effective within the limits set by its scope. The evaluation nevertheless reveals the need for certain amendments to close possible loopholes, especially in relation to:

1. Beneficial ownership: The Directive deals only with interest payments made for the immediate profit of individuals resident in the EU. These individuals have opportunities to circumvent the Directive by using an interposed legal person or arrangement situated in a non-EU country, which does not tax the payments. The Commission, therefore, proposes asking paying agents to use, in selected cases,

the information already available to them under the anti-money laundering provisions about the actual beneficial owner(s) of a payment made to a legal person or an arrangement (look-through approach).

2. Definition of paying agent: Under the Directive, as an anti-avoidance measure, some entities are obliged to apply the Directive when they receive an interest payment, by acting as paying agent. This concept of 'paying agent upon receipt' seems to have generated uncertainty. The Commission, therefore, proposes to move to an approach based on a 'positive' definition of the intermediate structures (including trusts, transparent entities …) to be charged with obligations to act as a "paying agent upon receipt". This 'positive' definition would be based on substantial elements rather than on their legal form.

3. Treatment of financial instruments equivalent to those explicitly covered: At present, the Directive can be circumvented by rearranging one's financial affairs in such a way that income which is equivalent to interest from debt-claims remains outside the formal definition of interest payment. The Commission, therefore, proposes to include structured products in the scope of the Directive if the capital is protected and the return is predominated. Also included are non-UCITS funds with domicile in an EU member state, further collective investment schemes with domicile outside the EU and life insurance policies with minimal insurance elements and liquidity features. When might these changes take effect?

The European Commission has voted to adopt the proposals, but they are some way from becoming law. The earliest possible start date, assuming a smooth running of the process to implement the revised Directive, would be 1 January 2011. The process can be summarised as follows:

1. ECOFIN (European Council of Finance Ministers) met in December 2008 to commence discussions on the proposals;

2. Unanimous agreement needed by all member states to adopt the revised Directive;

3. Once the revised Directive is in force, each member state would have to enact this in their domestic legislation;

When the initial Directive was introduced, certain countries made their agreement conditional on other non-EU countries (such as Andorra, Liechtenstein, Monaco and Switzerland) also adopting the Directive. The European Commission, furthermore, seeks bilateral agreements (equivalent to the regulations of the Directive) with other third-party states (e.g. Singapore and Hong Kong).

It is anticipated that some countries will put forward similar conditional agreements this time, in which case there could be further delay while agreement is sought from these non-EU countries.

What should the wealth management industry do now?

The EU has specifically identified certain types of structured products, non-UCITS funds with domiciles in an EU member state and further collective investments with domiciles outside the EU schemes, which produce an interest-like return and believes that these fall within the intentions of the original Directive. Given this, it is probably unlikely that such financial products will be left out of scope entirely in any revised Directive.

Wealth managers should review their products (structured products and collective investment schemes) and structures (interposing legal entities) provided to wealthy clients to identify those which might fall within the scope of the revised Directive, and consider the impact of this in terms of the associated data and reporting requirements.

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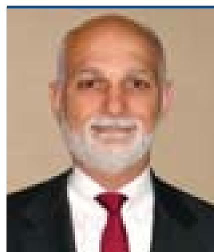

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