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PROPOSED AMENDMENTS TO THE EU TAXATION SYSTEM OF INCOME DERVING FROM INTEREST

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ABSTRACT

Council Directive 2003/48/EC on taxation of savings income in the form of interest payments (the "EU Savings Directive"), came into force in the EU Member States on July 1st 2005 and was transposed into Croatian legislation by the latest General Tax Act (Public Gazette No. 147/08 and amendments in Public Gazette No. 18/11). The Directive aimed to enable savings income in the form of interest payments paid 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 their State of residence.

However, when the Directive became applicable, it was apparent that further adjustments were necessary in order to close legal loopholes that enabled taxpayers to evade effective taxation.

The goal of this paper is twofold – to reveal the most common artificial legal schemes used in order to circumvent Directive 2003/48/EC, as well as to present the Commission's Proposal COM/2008/727 designed to redress the existing legislative loopholes and thus curb tax evasion.

Key words: tax evasion, taxation of savings, direct tax harmonization, anti-money laundering measures

JEL classification: K340

1. INTRODUCTION

The European Parliament, in its Resolution of 10 February 2010 on promoting good governance in tax matters, emphasized the problem of tax evasion and tax avoidance as one of the chief contributors to the latest economic crisis, costing the EU annually around 2, 5% of its GDP in revenue losses.[1] An attempt to counter tax evasion and restore fair market competition is Council Directive 2003/48/EC on taxation of

[1] Studies conducted for the Republic of Croatia (for the year 2000) suggest it is between 5,5-7,5 of the country's GDP (MADŽAREVIĆ-ŠUJSTER, 2002:138).

savings income in the form of interest payments (hereafter "EU Savings Directive"), which contains measures destined to prevent individuals from evading effective taxation of interest payments received on savings deposited in another Member State.

However, despite high expectations, in practice the Directive proved to suffer from some substantial legal loopholes and it became apparent that amendments were indispensable in order to prevent taxpayers to evade effective taxation. In this paper the authors will reveal the most common artificial legal schemes used in order to circumvent Directive 2003/48/EC and present the Commission's Proposal COM/2008/727 designed to redress the existing legislative loopholes.

In chapter two of the paper, the authors will present the development of legislative models destined to combat tax evasion concerning income deriving from interest payments. The third chapter of the paper will be dedicated to defining the territorial scope of the EU Savings Directive and the methods it provides to ensure effective taxation of interest payments made to individuals. The fourth chapter of the paper deals with definitions of the Directive's basic notions, giving a critical view of the existing legal loopholes they create and various amendments of the Directive designed to fill the existing gaps, as foreseen by Commission's Proposal COM/2008/727 final. The fifth chapter of the paper will be dedicated to the analysis of the anti-money laundering measures, as laid down in Directive 2005/60/EC, to which the EU Savings Directive makes explicit reference for the purpose of identifying the beneficial owner. In the last and concluding chapter, the authors will assess the impact of the EU Savings Directive and will recap the amendments, as formulated in the Commission's Proposal, destined to offset the shortcomings in the current directive.

2. TAXATION OF INCOME RECEIVED FROM INTEREST PAYMENTS: MODELS OF COMBATTING TAX EVASION AND ITS RELEVANT LEGISLATIVE FRAMEWORK

Extensive globalization left the States to face its negative consequences: mobility of people, capital, development of untraceable cross-border transactions and harmful tax competition, all which constitute elements aggravating the risk of tax evasion and fraud (SALVAT, 2010:103). Capital movement was liberalized within the EU by Directive 88/361/EEC and extended to relations with third States by the Treaty of Maastricht (now Article 63 of the Treaty on the functioning of the European Union, ex-Article 56 of the Treaty establishing the European Community). Initially, the States relied on an exchange of information mechanism provided for by Article 26 of the OECD Model Tax Convention, contained in a more or less developed network of bilateral conventions against double taxation (CASTAGNÈDE, 2010). Since States, when concluding these bilateral conventions, could choose between various forms of exchange of information: spontaneous exchange, exchange upon request and the automatic exchange of information and could limit its material scope depending on whether the contracting States concluded a "minor information clause" (exchange of information for the sole purpose of carrying-out the Double Tax Convention) or a "major information clause" (covers also persons who are not residents of the two contracting States) (LANG, 2010:151), the effectiveness of this mechanism was hindered. In the absence of an extensive automatic exchange of information system between two Member States, tax evasion in the matter of income in the form of cross-border interest payments, received by individuals in another EU Member State, was fairly easy. Although, the Member States were already applying Directive 77/799/EC on mutual assistance between tax authorities in the field of direct taxation, which provides for an exchange of information and coordination of investigative actions in cases of tax fraud, this exchange could be made conditional on some aspects of internal law (Commission (SEC (2008) 2767). It became apparent that a more effective legal intervention was necessary in order to combat tax evasion and distortion of the common market.

Since effective taxation of income in the form of interest payments to individuals could not be achieved properly by the Member States, the Union was entitled to act and adopt measures, according the principle of subsidiarity, as set out in Article 5 of the Treaty on the European Union.

Various models were taken into consideration. The withholding tax model formed by the European Commission, which proposed an EC - wide withholding tax on interest at a rate of 15%, judged reasonable but not excessive, was rejected by the Council. The next model was the so-called co-existence model (offering a choice between a 20% withholding tax or exchange of information), "*but by then the winds changed, possibly under the OECD Report on Harmful Tax Competition and focus shifted from "minimum taxation in the source State" to "effective taxation in the residence State of the recipient", and from the co-existence model to single mandatory exchange of information model.*" (TERRA and WATTEL, 2005:641)

Finally, as a result, the EU Savings Directive was adopted and came into force in the EU Member States on July 1st 2005. It also became part of Croatian legislation through the latest General Tax Act and its amendments (Public Gazette of the Republic of Croatia, No. 147/08 and No. 18/11).

3. TERRITORIAL SCOPE OF THE EU SAVINGS DIRECTIVE AND METHODS DESTINED TO ENSURE EFFECTIVE TAXATION OF INTEREST PAYMENTS MADE TO INDIVIDUALS

3.1. Territorial scope

Although the EU Savings Directive is a legal source belonging to the so-called secondary sources of EU Law and can thus only be applied in the Member States, its application was extended, by means of international agreements bearing equal or equivalent measures, concluded with the dependent territories of the UK (Guernsey, Jersey and the Isle of Man), UK overseas territories (Anguilla, Montserrat, British Virgin Islands, Turks and Caicos Islands and the Cayman Islands), dependent territories of the Netherlands (Netherlands Antilles and Aruba) and certain non-EU countries. The latter countries are: Switzerland, Monaco, San Marino, Andorra and Lichtenstein. Namely, the Member States agreed to start applying the EU Savings Directive only under the condition that these dependent and associated territories, as well as the aforementioned Third States start applying the similar agreements at the same date as the Directive.

Agreements with dependent and associated territories differ from Third Country Agreements in more than one aspect. Firstly, the Third Country Agreements have been concluded between the European Community and the relevant Third State, whereas agreements with dependent and associated territories were concluded separately with each Member State. Secondly, while the latter agreements ask for measures *equal* to those provided for by the EU Savings Directive, the Third Country Agreements only need to provide for *equivalent* measures. Thirdly, agreements with dependent and associated territories apply reciprocally, that is to say that the foreseen measures apply equally to inbound and outbound payments of interest savings (made from the dependent and associated territories to the EU Member State and *vice versa*) whereas the Third Country Agreements apply only to such payments made from these countries *to* an EU Member State.

3.2. Methods destined to ensure effective taxation of interest payments made to individuals, resident in another EU Member State

As it has been stated before, in chapter 2 of the present paper, an automatic exchange of information system was judged to be the best method to ensure effective taxation of interest payments made to individuals**,** resident in another EU Member State. Therefore, the EU Savings Directive obliges a paying agent to automatically report, at least a minimum amount of information, to its competent tax authority, whenever it is making interest payments to a beneficial owner who is resident of an EU Member State other than the Member State the paying agent is established in. The minimum amount of information refers to: (a) the identity and residence of the beneficial owner, (b) the name and address of the paying agent, (c) the account number of the beneficial owner or identification of the debt claim giving rise to interest and (d) the amount of interest paid or credited, or the amount of proceeds from the sale or redemption of the debt claim itself or the funds units giving rise to interest.

Subsequently, the competent tax authority in the Member State of establishment of the paying agent automatically exchanges this information with the competent tax authority in the Member State of residence of the beneficial owner, which can then tax this income according to its national tax legislation. The Directive obliges Member States to automatically exchange information at least once a year, for all interest payments made that year, within six months following the end of the tax year in the Member State of the paying agent.

A consistent application of the automatic exchange of information method would in fact result in an EC-wide abolishment of the bank secrecy. Since it became apparent that some of EU's main competitors in the financial sector (e.g. Switzerland) would not give up their cherished bank secrecy, some Member States strongly advocated the application of both the automatic exchange of information system as well as an alternative withholding tax system. Therefore, as derogation to the automatic exchange of information method, an alternative mechanism was provided for Austria, Belgium and Luxemburg. These countries are allowed to withhold a tax at a rate of 15% during the first three years of application of the EU Savings Directive, 25% for the subsequent three years and finally, since 1 July 2011, at a rate of 35%, levied on the amount of interest. The amount of tax collected is then distributed between the Member State levying the tax (it is entitled to 25% of the revenue, as a compensation for services rendered) and the resident State (which receives 75% of the amount). All Member States levying a 35% withholding tax are obliged to enable the beneficial owner a voluntary disclosure procedure. This means that, when the beneficial owner expressly authorizes the paying agent to report information on him and the interest he received to its tax authority, which would then transfer the information to the tax authority of the State of residence of the beneficial owner, the paying agent needs to do so. The withholding tax regime was meant to be only a transitional arrangement, which should come to an end when the European Council decides that the USA, Switzerland, Lichtenstein, Andorra, San Marino and Monaco are willing to disclose requested information on beneficial owners receiving interest payments from paying agents established within their territory. Since these events, up to this date, have not yet occurred, the provisional arrangement is therefore still applicable in Austria and Luxembourg (Belgium started applying the automatic exchange of information method as of 1 January 2010).

Concerning agreements concluded with dependant and associated territories, some of them provide automatic exchange of information, whereas others withhold a tax.[2] Third Country Agreements provide for (a) application of a withholding tax with revenue sharing and (b) a voluntary disclosure of information upon an express request of the beneficial owner and (c) exchange of information upon request in cases of tax fraud.

4. MAIN FEATURES CONSTITUTING THE MATERIAL SCOPE OF THE SAVINGS DIRECTIVE

As stated before, the EU Savings Directive aims to enable savings income in the form of interest payments, paid in one EU Member State to beneficial owners, who are individuals resident for tax purposes in another Member State (cross-border payments), to be made subject to effective taxation, in accordance with the laws of the State of residence. Hence, the scope of following legal notions must be clearly distinguished: 1. interest payments, 2. beneficial owner, 3. paying agent.

4.1. The definition of interest payments

Four categories of income fall under the scope of the definition of interest payments, as laid down in Article 6 of the EU Savings Directive: (a) interest, paid or credited to an account, related to debt claims of every kind (etc.); (b) interest accrued or capitalized at sale, refund or redemption of these debt claims; (c) interest distributed by certain collective investment vehicles investing in debt claims, and (d) income from sale, refund or redemption of participations in such collective investment entities (TERRA and WATTEL, 2005). The first category corresponds to the definition of interest payments as laid down in Article 11 of the aforementioned OECD Model Tax Convention. It consists of two aspects – the positive aspect – what is to be considered interest payments and the negative aspect – what falls out of the scope of the definition. The latter group concerns penalty clauses or charges, pensions and insurance benefits (LOPES COURINHA, 2006). The positive aspect of the definition encompasses all

[2] Four of the dependent territories (Aruba, Anguilla, the Cayman Islands and Montserrat) have provided automatic exchange of information from the date of the start of application of the relevant agreements on 1 July 2005. Since that date the following territories have also shifted to automatic exchange of information: Guernsey (as from 1 July 2011), Isle of Man (as from 1 July 2011), the British Virgin Islands (as from 1 January 2012), and Turks and Caicos Islands (as from 01 July 2012) . The dissolution of the Netherlands Antilles on 10 October 2010 resulted in two new constituent countries (Curaçao and Sint Maarten), which continue to levy a withholding tax on the same terms as Luxemburg and Austria, and three special municipalities which are part of the Netherlands (Bonaire, Sint Eustatius and Saba) and provide automatic exchange of information.

kinds of interests deriving from debt claims, concerning notably bonds, debentures, deposits and loans. Vogel for instance, defines interest "*as remuneration received for making capital available"* (VOGEL, 1997:731). Category (b) refers to all interests in the form of capitalized interest or profits made at redemption or refund, the so-called capital gains. Category (c) refers to income deriving from interests received indirectly in the form of distribution from three types of investment funds – UCITS (Undertakings of Collective Investment in Transferable Securities) set up according to Directive 85/61/EEC (UCITS Directive), entities within the paying agent upon receipt concept who opted to be treated as UCITS (to be elaborated in chapter 4.3) and non-EU undertakings for collective investment.

Attention needs to be drawn to the question of asymmetrical treatment of different sorts of investment funds. The UCITS funds are investment funds that have been established in accordance with the abovementioned UCITS Directive. Once registered in one of the Member States, the units of an UCITS fund can be freely marketed across the EU. Currently, according to Article 4(2) of the EU Savings Directive, when an economic operator makes an interest payment to an entity established within the EU for the direct benefit of an individual, this entity shall be treated as a paying agent upon receipt, meaning that it will have to apply the Directive instead of the economic operator (this will be elaborated in detail within the chapter 4.3). However, if this entity proves that it is an UCITS fund or an entity which opted to be treated as such (the Member State of establishment must issue a corresponding certificate) it will not have to apply the Directive, when receiving the interest payment from an upstream economic operator. On the other hand, when an UCITS fund, an entity which opted to be treated as such or an investment fund established outside the territorial scope of the Directive, distribute income deriving from investments in debt-claims, this income falls under the definition of interest payment (Article 6 (1) (c)). The same goes for income from sale, refund or redemption of participations in such collective investment entities (Article 6 (1) (d)).

Unequal treatment may occur concerning investment funds which, although fulfilling all the necessary criteria for being treated as an UCITS fund, simply do not apply for such authorisation (non-UCITS funds). Two situations can arise. When a non-UCITS fund lacks legal personality (has not been incorporated) it can either be treated as a paying agent upon receipt (which needs to apply the Directive immediately upon receipt of the interest payment) or it can opt to be treated as a UCITS fund (in which case it needs to apply the Directive when distributing the income to individuals). On the other hand, when a non-UCITS fund has legal personality (e.g. *SICAV* in Belgium), the interest income it channels falls entirely out the scope of the EU Savings Directive. The income it receives from an upstream economic operator is not being distributed to an individual but a legal person, therefore the economic operator has no obligation to report or withhold tax, nor does the incorporated non-UCITS need to apply the Directive, since legal persons are expressly excluded from the "paying agent upon receipt" concept (Article 4(2) (b).

The second review of the EU Savings Directive, based on data provided for by EFAMA (European Fund and Asset Management Association), revealed that there has been a shift in the market towards non-UCITS funds (22% in 2002 to 25% in 2010) (Commission COM(2012) 65 final; page 11). This only encouraged the Commission to curb this unwanted asymmetry in treatment among non-UCITS funds by proposing an amendment to the current definition of interest payment, as laid down in the Article 6 of the EU Savings Directive. Rather than making a reference to the UCITS Directive, the amended Article 6(1) would include a reference to the registration of the undertaking or investment fund or scheme according with the rules of any Member State, thus submitting UCITS and non-UCITS funds alike to the same treatment. Should the Amending Proposal COM/2008/727 (final) entre into force, all income deriving from investments in debt-claims, is to be considered as interest payment, whether it is distributed directly or through an undertaking for collective investment, collective investment fund or scheme registered in accordance with the rules of any Member State or established outside the territorial scope of the Directive and in the latter case, irrespective of its legal form or whether it is an open or closed investment fund.

Based on their investment policy, there are different kinds of funds: equity funds, bond funds, money market funds and balanced funds (ADEMA, 2009). Whereas the answer to the question of application of the EU Savings Directive is clear in the case of the first three funds (it applies to income received through bond funds and money market funds and does not apply to income deriving from equity funds), it is less straightforward when concerning income deriving from balanced funds. The paying agent should try to ascertain the proportion of income deriving from interests as defined in category (a) and apply the Directive only to that income. If the paying agent is unable to establish this proportion, the total amount of the income shall be considered as deriving from interests.

The question of how to proceed with income gained from refund or redemption of units was solved by establishing a threshold of 25% (as of 1 January 2011) of the fund's assets that need to be invested in/directly into debt-claims, in order for the entire proceeds from such a transaction to fall under the definition of interest payment (LARKING, 2001:228). The extension of equal treatment of redemption of UCITS units and non-UCITS units is also proposed in Commission's Proposal COM/2008/727, insofar as these funds invest at least 25% of their assets into debt-claims.

The definition of "interest", as conceived in the current Article 6, was not intended to apply to innovative financial products, accompanied by an express statement that the issue should be re-examined during the first review of the EU Savings Directive (WEBER, 2010:538). This definition follows the one used by the OECD in the Model Tax Convention, which considers that "*payments made under certain kinds of non-traditional financial instruments where there is no underlying debt do not normally fall under the definition of interest*" (see Paragraph 21.1. of the Commentary on Article 11 of the OECD Model Tax Convention). It was deemed too complicated for the paying agents to know the sophisticated features of an instrument, or the connection between its performance and the income it generates. However, the Commission, in its Proposal of Amendments to the EU Savings Directive (page 6) recognized that the extensive use of such innovative financial products, notably structured securities, which feature flexibility, a low risk and a rather safe return on invested capital provided income in a way similar to the one deriving from debt claims. Namely, data has shown that the market for structured financial products (where the current outstanding amount of sales in covered EU markets is EUR 767,3 billion) had undergone rapid development in general with an average annual increase of more than 30% (Commission, COM(2012)65 final; page 10,11).

This only supports the need to include such products into the scope of the Directive. The introduction of a general “substance over form” principle, as proposed by the cited Paragraph 21.1. Commentary on Article 11 of the OECD Model Tax Convention, although judged helpful by the Commission and the Member States, was discouraged by market operators, claiming that, without proper guidelines, disputes with clients were bound to arise. Also, the Commission considered drawing up a list of innovative financial products in each Member State, which would fall under the definition of interest payment, but this solution was deemed too rigid to keep up with market developments. Therefore, a compromise was attained by extending the scope of the Directive to securities of any kind where the investor (a) knows the conditions of the return on capital at the issuing date, and (b) at the end of the term, receives at least 95% of the capital invested.

Also, further amendments would concern some life insurance contracts where the biometric risk coverage is lower than 5% and its performance is linked to income from interest. These contracts are actually interest-generating securities concealed in life insurance contracts that are actually redeemable at a limited cost.

4.2. Beneficial owner

The beneficial owner of an interest payment is an individual who receives the payment, or for whom the payment is secured, unless this person proves that it was not received or secured for his own benefit (Article 2(1) of the EU Savings Directive). An individual receiving an interest payment will not be considered a beneficial owner if: (a) he/she acts as a paying agent for another individual or if (b) he/she is in fact an ”intermediary agent”, that is if he/she acts on behalf of another individual (disclosure of identity of the beneficiary is mandatory), or (c) on behalf of a legal person (or an entity subject to tax under the general arrangements for business taxation) or (d) on behalf of an UCITS fund (or an entity that opts for being treated like an UCITS fund) (Article 2(2) of the EU Savings Directive). In the latter case, further safeguards were deemed necessary. The recipient must reveal the name and address of the entity that opted to be treated like an UCITS fund to the economic operator making the payment, who in return must communicate this information to its national tax authority.

If the paying agent suspects that the person receiving the interest payment is not the actual beneficial owner, it shall take reasonable measures to ascertain the identity of the true beneficial owner. If it fails to do so, it shall treat the recipient as the beneficial owner. (Article 2(3) of the EU Savings Directive)

The Directive applies only to payments made *directly* to individuals. Payments made through legal persons or other legal entities fall out of the scope of the EU Savings Directive. Such a limited scope made way for various schemes of evading taxation, even though the beneficial owner of the interest payment is indeed an individual who is resident in another Member State and the Directive should apply.

In order to combat such tax evasion, the Commission proposed some substantial modifications to the current definition of the term “beneficial owner”.[3]

The first alteration can be found in point (b) of the proposed Article 2(1), where exemptions from the concept of beneficial owner can be found. An individual receiving an interest payment will not be considered as a beneficial owner if he/she acts

[3] COM(2008)727 (final), Explanatory Memorandum, page 3.

on behalf of an entity or a legal arrangement and discloses the name, the legal form and the address of the place of effective management of the entity or, in the case of a legal arrangement, the name and the permanent address of the person who primarily holds legal title and primarily manages its property and income, to the economic operator making or securing the interest payment. This represents an entirely different approach from the current approach, as stated in Article 2(1) (b). In a way, the exemption is widened to the extent that it now encompasses individuals acting on the behalf of all entities or legal arrangements and not just legal persons, or entities subject to tax under the general arrangements for business taxation, or on behalf of an UCITS fund (or an entity that opts for being treated like an UCITS fund). However, in order not to be treated as the beneficial owner, the "intermediary" must disclose the name, legal form and address of effective management of this entity or legal arrangement to the economic operator making the interest payment.

Additionally, the Commission proposed the introduction of a new, third paragraph to Article 2, which directly refers to Directive 2005/60/EC on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (hereafter: Third Anti-Money Laundering Directive): "*Where an economic operator within the scope of Article 2 of Directive2005/60/EC makes an interest payment to, or secures such a payment for, an entity or a legal arrangement corresponding to those set out in Annex I, the definition in paragraph 1 of this Article shall include the beneficial owner, as defined in Article 3(6) of Directive 2005/60/EC, of such entity or legal arrangement".*[4]

The concerned economic operators, under the mentioned Article 2 of the Third Anti-Money Laundering Directive, are: (1) credit institutions; (2) financial institutions; (3) some legal or natural persons acting in the exercise of their professional activities.[5] When these economic operators are making interest payments to certain entities or legal arrangements listed in the newly proposed Annex I to the EU Savings Directive (which will be discussed later, in the chapter 4.3) they must apply Article 3(6) of the Third Anti-Money Laundering Directive, in order to establish the true beneficial owner of the interest payment.

It is therefore indispensable to present the definition of "beneficial owner", under the Third Anti-Money Laundering Directive. The term "beneficial owner", means the natural person(s) who ultimately owns or controls the customer and/or the natural person on whose behalf a transaction or activity is being conducted. The beneficial owner shall at least include, in the case of corporate entities, (a) the natural person(s) who ultimately owns or controls a legal entity through direct or indirect ownership or control over a sufficient percentage of the shares or voting rights in that legal entity, including through bearer share holdings, other than a company listed on a regulated market that is subject to disclosure requirements consistent with Community legislation or subject to equivalent international standards; a percentage of 25 % plus

[4] COM(2008)727 (final), page 15

[5] (a) Auditors, external accountants and tax advisors; (b) notaries and other independent legal professionals, when they participate in, (i) buying and selling of real property or business entities; (ii) managing of client money, securities or other assets; (iii) opening or management of bank, savings or securities accounts; (iv) organisation of contributions necessary for the creation, operation or management of companies; (v) creation, operation or management of trusts, companies or similar structures; (c) trust or company service providers not already covered under points (a) or (b); (d) real estate agents; (e) other natural or legal persons trading in goods, only to the extent that payments are made in cash in an amount of EUR 15 000 or more, whether the transaction is executed in a single operation or in several operations which appear to be linked; (f) casinos.

one share shall be deemed sufficient to meet this criterion, or (b) the natural person(s) who otherwise exercises control over the management of a legal entity (Article 3(6) (a) of the Third Anti-Money Laundering Directive)

In the case of legal entities, such as foundations, and legal arrangements, such as trusts, which administer and distribute funds, one can differentiate three situations. In a situation where the future beneficiaries have already been determined, the beneficial owner will be the natural person(s) who is the beneficiary of 25 % or more of the property of a legal arrangement or entity. In a situation where the individuals that benefit from the legal arrangement or entity have yet to be determined, the beneficial owner is the class of persons in whose main interest the legal arrangement or entity is set up or operates. Otherwise, it will be the natural person(s) who exercises control over 25 % or more of the property of a legal arrangement or entity (Article 3(6) (b) of the Third Anti-Money Laundering Directive).

The Third Anti-Money Laundering Directive, in order to set a clearer definition of the beneficial owner, sets a "25% plus one share" and a "25% of property" ownership threshold, deemed sufficient enough to meet the criterion of ultimate ownership or control. Still, when in face with complex structures featuring multiple layers of trusts, entities and companies, it is questionable who the real beneficial owner is. These types of structures of ownership designed to obfuscate the true beneficiary should definitely be treated as cases where enhanced customer due diligence should be conducted in order to pierce through a multi-layered corporate veil (see chapter 5).

4.3. Paying agent

For the purposes of the EU Savings Directive, "paying agent" means any economic operator who pays or secures interest *directly* to its *beneficial owner*, regardless of whether he is also the debtor of the debt claim giving rise to the interest or solely the appointed operator. In other words, the term "paying agent" encompasses all kinds of economic operators (individuals, legal persons or entities of any kind) who are the "last link in the chain of downward payments of interest", paying the interest directly to the beneficial owner. They have the obligation either to report information about the payment to their tax authorities or to withhold a tax, depending on which method is applied in their State of establishment (see *supra*, chapter 3).

If this definition were to be the only definition of the paying agent, it is clear that all payments made to entities established within the Community, other than individuals, would fall out of the scope of the Directive. However, some types of entities, mostly lacking legal personality, such as trusts or civil partnerships, are often regarded by the Member States as "tax transparent" entities. This means that the income they receive is generally allocated, for tax purposes, to the participants of the entity, regardless of the moment of effective distribution of this income to the participants. In some occasions, these participants might be individuals resident in another Member State. Bearing in mind that these entities may not be subject to close supervision by tax authorities of their Member State, to the extent that individuals could easily circumvent the Directive, by interposing such a tax transparent entity, between the paying agent and themselves, the EU Savings Directive set up the concept of a – "paying agent upon receipt" (Art. 4(2)).[6]

When the "initial" paying agent, or rather the upstream economic operator, pays interest to such an entity established within the EU, the Directive applies in two stages. Firstly, the upstream economic operator will convey information to its national tax authority on the name and address of the entity and the total amount of interest paid to it. The tax authority of the Member State of establishment of the economic operator will then communicate this information to the tax authorities in the State of establishment of the entity. Secondly, the entity itself will apply one of the methods stated in the Directive which applies in its State of establishment (automatic exchange of information about the beneficial owner and the amount of interest the entity will distribute to him/her or withholding tax).

It is important to note that these entities, due to the fact that they are often considered transparent for tax purposes in Member States, must apply the Directive at the moment of receipt of the interest payment and not distribution of the interest to their beneficial owners. Hence the term "paying agent upon receipt".

The reason for this two-staged application of the Directive is the following. The upstream economic operator has no knowledge of the identity or residence of the actual beneficial owner of the interest payment, whereas the entity receiving the interest payment or rather, the "paying agent upon receipt" necessarily knows of which participants it is constituted and can therefore apply the Directive when its participants are individuals resident in a Member State other than the one the entity is established in. Member States applying the withholding tax method, may provide measures that oblige the upstream economic operator to apply the withholding tax instead of the entity, when the entity is establish in another Member State, unless this entity has formally agreed that the paying agent discloses information on the name and address of the entity and the amount of interest paid to it (Article 11 (5) of the EU Savings Directive).

Some entities are expressly excluded from the "paying agent upon receipt" concept. These are all legal persons (with the exception of certain Swedish and Finnish legal persons, which therefore are to be considered as "paying agents upon receipt"), entities whose profits are taxed under general arrangements for business taxation and UCITS investment funds. When interest payments are made to these entities, the Directive does not apply. But, when they distribute income to individual beneficial owners resident in another Member State, this payment falls under the scope of the EU Savings Directive, provided that it meets the criteria set in Article 6 of the EU Savings Directive (definition of interest payment).

Although it was expected that the definition of the "paying agent" would prevent misuse of the Directive, its scope was proven to be too narrow in practice (Commission COM(2008)727 (final), page 4). Namely, the Directive is easily circumvented by artificially channelling the interest payment through an economic operator established outside the territorial scope of the Directive or agreements with similar measures. The second review of the EU Savings Directive confirmed the widespread use of untaxed offshore structures interposed between the payer and the ultimate beneficiary in order to obscure the actual beneficial ownership: 35% of the

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[6] The five non-EU countries applying equivalent measures did not accept the concept of the paying agent upon receipt.

non-bank deposits in Member States (65% for deposits held in Savings Agreements countries) are held by such structures located in offshore jurisdictions (Commission, COM (2012) 65 final; page 7).

Another way of evading tax is the case where an economic operator established within the EU distributes the interest to its branch established outside of the territorial scope of the Directive (for instance the USA) which then, in return makes the payment to the individual resident in another Member State. The initial economic operator does not have the obligation to apply the Directive, because it is not paying the interest to an individual and the second economic operator is not bound at all by the Directive, being established outside its territorial scope. The same goes for payments made to other interposed legal persons or trusts situated outside the territorial scope of the Directive.

Therefore, the Commission in its Proposal of Amendments to the EU Savings Directive intends to substantially modify Article 4 and the definition of the "paying agent". In the case where interest payments are made to certain entities and legal arrangements, whose place of effective management is outside the territorial scope of the EU Savings Directive, the proposed amendment to Article 4(1) would impose an obligation on paying agents within the EU to apply a so-called "look-through approach". This means that they would have to make use of information on beneficial owners, already available to them based on anti-money laundering measures they are already required to apply, as laid down in the aforementioned Third Anti-Money Laundering Directive (special attention will be paid to these measures in chapter 5 of this paper). The Commission believes[7] that these measures ensure identification of the beneficial owner and when there are indications that the beneficial owner is in fact an individual resident in another Member State, the paying agent should "look through" the interposed entity or legal arrangement and consider the interest payment to be made directly to the beneficial owner.

In order to limit uncertainties as to which entities should be regarded in such a way, a list of entities and legal arrangements whose place of effective management (not establishment!) is in a certain country or jurisdiction, outside the territorial scope of the EU Savings Directive or corresponding agreements, which does not ensure proper taxation of income paid to such entities, was added as Annex I.[8]

Proposed amendments to Article 4(1) would also cover situations in which an economic operator is making payments to another economic operator established outside the territorial scope of the Directive or similar agreements with Third Countries and jurisdictions, for which it has proof that they will subsequently be distributed to individuals resident in another Member State. Again, the Community paying agents would be obliged to apply a "look through approach" and consider such payments to be made for the immediate benefit of the individual and should therefore apply the Directive. This would put an end to the circumvention of the Directive through the misuse of international networks of financial institutions (WEBER, 2010;527).

The "paying agent upon receipt" concept, although believed to be sufficiently resistant to misuse, in practice proves to suffer from legal loopholes and requires modifications as well. The main problem lies in exempting "entities whose profits are

[7] COM(2008)727 (final), page 3

[8] For example: Bahamas – trust, foundations, international business company; Bahrain – Financial trust, Maldives – all the companies, partnerships and foreign trust ...

taxed under general arrangements for business taxation" from being treated as paying agents upon receipt. This is due to the fact that certain Member States consider some entities as being generally subject to corporate or similar tax, while not obliging them to keep records of any kind (e.g. partnerships in Austria). Such discrepancies enable some Member States to "*maintain or even increase (in relation to other participating countries) the attractiveness of their financial markets, despite the implementation of the Savings Directive*" (GLÄSER, HALLA, 2006:38). These entities are mostly trusts and civil law partnerships.

The proposition of extending the "paying agent upon receipt" concept to all entities and legal arrangements established in other Member States was rejected as being administratively too burdensome for upstream economic operators. Instead, an approach based on a positive definition of intermediate structures obliged to act as a "paying agents upon receipt" was adopted. This meant shifting the obligation to apply the EU Savings Directive from the economic operators on to various trusts, foundations and other legal arrangements. The definition is based more on substantive elements than the legal form. Its key elements are: (a) it is an entity or legal arrangement, (b) which, under the *general rules for direct taxation applicable* in the Member State in which the entity or legal arrangement has its *place of effective management*, (c) is *not taxed on its income* or on the *part of its income*, arising to its *non-resident participants*, including any interest payments.

The "paying agent upon receipt" concept underwent the following important changes. First of all, whether there is effective taxation of the income of such an agent is assessed according to the laws of the Member State where it has its place of effective management, irrespective of its place of establishment. For this purpose, a legal arrangement shall be considered to have its place of effective management in the country where the person who primarily holds legal title and primarily manages its property and income has his or her permanent address.

Additionally, in order to lighten the administrative burden lying upon economic operators, an indicative list of entities and legal structures that should in all cases be considered as "paying agents upon receipt" is joined as Annex III. If such entities or legal arrangements have the place of effective management of their movable assets in one of the Member States (determined by the residence of the main trustee or administrator responsible for movable assets), they shall be treated as "paying agents upon receipt", irrespective of the laws under which these trusts or similar arrangements have been set. This means that a trust or foundation established in e.g. Singapore (outside the scope of the Directive), but whose place of effective management is within the EU, will be treated as "paying agent upon receipt" and its management must therefore apply the Directive, upon receipt of interest payments from an upstream economic operator.

Subsequently, "*entities whose profits are taxed under general arrangements for business taxation*" are removed from the list of exemptions from the "paying agent upon receipt" and "*non-taxation of the income, arising to its non-resident participants, including any interest payments"*, was added as a constituting part of the definition of the paying agent upon receipt. By doing so, the amended version of the definition would put a stop to discrepancies which occur in practice, where some entities are considered to be subject to general business income tax, but are not obliged to keep track of their income, thus enabling tax evasion.

Other exemptions from the concept were also changed. The following entities or legal arrangements should not be treated as "paying agents upon receipt": (a) UCITS funds or non-UCITS funds whose income is covered by points (c) and (d) of the definition of interest payment (they apply the Directive upon distribution), (b) if they are serving management of assets of a pension fund or insurance business, (c) if they are serving exclusively charitable purposes in the Member State of residence and (d) if it is a shared beneficial ownership for which the economic operator making the payment has established identity and residence of all beneficial owners and is therefore acting as a paying agent, instead of the entity or legal arrangement.

Finally, the proposed amendment expressly defines beneficial owners within these entities or legal arrangements, as being individuals who are legally entitled to the assets or the income of the entity or legal arrangement, or, in the absence of such, individuals who have directly or indirectly contributed to the assets giving rise to the interest payment. In terms of trust law, if there is a beneficiary of the trust, he/she would be considered as the beneficial owner. If there is no identifiable beneficiary, the principal settlor should then be considered as its beneficial owner. When neither the beneficiary, nor the principal settlor are identifiable, the paying agent upon receipt becomes a paying agent upon distribution and must apply the EU Savings Directive when an individual becomes entitled to the interest.

Again, there is a two-staged application of the Directive. First, the upstream economic operator must convey information about the name and place of effective management of the entity, or in case of a legal arrangement, the name and permanent address of the person who primarily holds legal title and manages the property and income of the legal arrangement (e.g. permanent address of a trustee) and the total amount of interest paid, to its national tax authority. In other terms, the economic operator must report on payments made to these entities or legal arrangement, irrespective of the identity of the beneficial owner or withhold 35% tax if it operates in Austria or Luxembourg (unless the entity or legal arrangement formally agree to disclose information). When the entity or legal arrangement is located in another Member State, this authority shall pass the information to its tax authorities. Secondly, this entity or legal arrangement must apply the provisions of the EU Savings Directive upon receipt of such income from an upstream economic operator. It must do so irrespective of the location of its bank account to which the payment has been made (it could be located outside of the territorial scope of the Directive, e.g. Hong Kong).

5. THE ISSUE OF IDENTIFICATION OF BENEFICIAL OWNERS AND THEIR RESIDENCES UNDER THE ANTI-MONEY LAUNDERING DIRECTIVE (2005/60/EC) AND ITS CORRELATION TO THE EU SAVINGS DIRECTIVE

It is clear that the effectiveness of the EU Savings Directive depends largely on the quality of information gathered by the paying agents which they later transmit to their competent authorities. Therefore, it is crucial to determine procedures necessary to allow paying agents to identify the beneficial owners and their residence. Minimum standards for establishing the identity and residency of the beneficial owner vary depending on the date the transaction or a contractual relation between the paying agent and the beneficial owner took place (Art. 3(2) (a) or (b) of the EU Savings Directive). Prior to 1 January 2004, the paying agent had to establish at least the name and address of the beneficial owner pursuant to the Know Your Customer principle set in Council Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering.[9] Although the latter Directive imposes the obligation on the paying agent to ascertain the identity of the beneficial owner, it does not lay down any further details. For business relations entered into after 1 January 2004, the EU Savings Directive demands the paying agent to determine, apart from name and address of the beneficial owner, also his tax identification number (TIN), or failing such number, his date and place of birth figuring on his passport or identification card. If some clients present a piece of identification issued by a Member State, but they declare themselves as residents of a third State, they must prove that, by submitting a tax residence certificate of that State.

Commission’s Proposal COM/2008/727 intends to substitute the reference to Council Directive 91/308/EEC with a reference to Council Directive 2005/60/EC (the Third Anti-Money Laundering Directive). Since this Directive derogates the prevision one, this proposition is only logical. Furthermore, the Third Anti-Money Laundering Directive raises the issue of identification and risk assessment to a higher level. Taking into consideration the importance of the quality of information gathered by the paying agent, we deem it necessary to further analyse regulations of the aforementioned Third Anti-Money Laundering Directive concerning identification of the beneficial owner.

Bearing in mind the complexity of business transactions, even more so when in the presence of a tax evasion scheme, identification of a beneficial owner is neither easy, nor uniform. „*The required identification evidence depends on the nature of the client and the degree of risk associated with the client or the business to be transacted*“ (BAZLELY, S., FORSTER, C.,2004). The Third Anti-Money Laundering Directive imposes on the paying agents (both from the financial and non-financial sector) a multitude of obligations but also provides them with a wide array of authorities when identification is concerned. These authorities enable the paying agent to perform a customer due diligence (according to Article 8 of the third Anti Money Laundering Directive) as a key element of the risk assessment process.

Customer due diligence does not only entail the identification of the *customer* and verification of the *customer's* identity on the basis of documents, data or information obtained from a reliable and independent source. It also imposes the obligation on the paying agent to identify the *beneficial owner* by taking adequate measures as to verify his identity, to the degree that the paying agent is satisfied that it knows who the *beneficial owner* is. Regarding legal persons, trusts and similar legal arrangements, this involves taking risk based and adequate measures to understand the ownership and control structure of the customer. It also imposes on the paying agent the obligation to obtain information on the purpose and intended nature of the business relationship and to monitor the business relationship, including scrutiny of transactions undertaken throughout the course of that relationship.

In other words, the extent of identifying the customer stands in direct correlation with the assessed risk. This process is known in both theory and practice as the „Know Your Customer (KYC)“ principle, a complex process where identification and verification of customer represent only the beginning[10].

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[9] As amended by Directive 2001/97/EC of the European Parliament and of the Council O.J. L 344, 28 December 2001

[10] On KYC principle and its difference from the KYB principle, see more in Hopton, D., (2005), *Money laundering; A Concise Guide for All Business*, Gower, Hampshire, pages 85, 89

An even more enhanced customer due diligence is foreseen in situations enumerated in Article 13 of the Third Anti Money Laundering Directive, that is where the customer has not been physically present for identification purposes, or in respect of cross-frontier correspondent banking relationships with respondent institutions from third countries, or when having business relationships with politically exposed persons residing in another Member State or in a third country or all other situations that represent a higher risk. On the other hand, in case of entering in business relations and transactions with certain credit or financial institutions covered by this Directive or beneficial owners of pooled accounts held by notaries, the Third Anti Money Laundering Directive provides for a more simplified customer due diligence**,** since the assessed risk for these kinds of transactions is presumably lower (Article 11).

6. CONCLUSION:

Due to liberalization of capital movement, tax evasion and tax avoidance are a growing problem in the EU. In order to successfully battle against these negative consequences of globalization, Member States must work together in order to coordinate their tax legislations and install effective procedures. In a territory such as the EU, where market operators make use of barriers being brought down, but tax authorities are still confined to their jurisdictions, an automatic exchange of information is judged to be the best way to tackle tax evasion and tax avoidance.

After long negotiations, the EU Savings Directive finally saw the light of day, on 1st July 2005. On average more than 4 million records have been sent each year from source countries to residence countries representing on average 20 billion euro of savings income (Commission(COM(2012)351final; page 6). On the other hand, the reviews of the Directive showed that the Directive fell short of its aim. When the EU Savings Directive was drafted, its scope was deliberately limited. For instance, innovative financial products were expressly left out of the scope of the Directive, provided that this decision be re-assessed at the occasion of the first review of the Directive. Indeed, the review showed that market distortions did occur to an extent, as individuals started rearranging their portfolios in such a fashion as to remain out of the definition of „interest payment" whilst still benefiting from all the features that such an investment entails. As stated before, the second review of the Directive revealed that the market for structured financial products has been increasing at more than 30% on average annually in recent years (*supra*, page 8). This wanted loophole, ought to be closed, by extending the scope of the Directive to such investment product in order to prevent further market distortions.

Other loopholes were less planned. For instance, it became apparent that the „paying agent upon receipt" concept needs fine-tuning for, in practice, individuals made use of certain entities that are incorporated, or are subject to general rules for business taxation, but are in fact considered to be tax transparent (e.g. partnerships in Austria). Also, inconsistent treatment of non-UCITS funds, based solely on the fact whether the fund is incorporated or not, gives the result that interest channelled through an incorporated non-UCITS funds, such as the Belgian SICAV, fall entirely outside the scope of the Directive, whereas interests distributed by UCITS funds or non-incorporated non-UCITS funds are always covered. The second review also showed a shift in the market towards investments in non-UCITS (*supra*, page 6).

Apart from closing detrimental loopholes, the Commission plans to lighten the administrative burden laying upon the economic operators, mainly banks. The entire Directive relies on the cooperation of market operators throughout the EU. These often point out the lack of clarity regarding as to which legal arrangements or entities should be treated as “paying agents upon receipt”. In order to enforce legal certainty, the Commission, in its Amending Proposal, suggests the introduction of a positive list of entities which should be regarded as such. It also suggests the introduction of a list of entities situated in non-EU jurisdictions which do not ensure effective taxation, in order to reduce uncertainties as to which entities the economic operators need to apply the „look-through“ approach. The paying agent would not need any cooperation of the selected jurisdictions outside the EU, as it would use the results of the Customer Due Diligence which it is already obliged to perform under the Third Anti-Money Laundering Directive.

Although, the Commission 's Amending Proposal of the EU Savings Directive could be considered as a mitigated solution, addressing solely the most flagrant loopholes, while leaving out further savings products, such as dividends payments, it is still not adopted. The reason for this is of purely political nature. Namely, the Member States are fearful that, by strengthening the automatic exchange of information within the EU, their financial markets will lose some of their attractiveness to other booming financial markets, such as Singapore, Hong Kong or Switzerland. Therefore, some Member States are reluctant to adopt the amendments to the EU Savings Directive, even though it would ensure better taxation of income deriving from interests. In a globalized market, where savers can move their savings around the world, wherever suits them best, the impact of such an amendment needs to be assessed on an international scale. Capital might relocate to other jurisdictions, where the banking secrecy is still a unquestionable bastion of the banking world. Although, in the short run, such taxation policy is understandable, in the long run harmful tax competition deprives the countries of their due income. The latest economic crisis emphasized budgetary strains in the Member States, caused by their will to satisfy often incongruent interest – the ones of the market operators and the ones of their citizens. It is therefore only advisable that the Council adopts the pending amendment proposal and that the EU makes use of its political influence on competing countries within the financial sector, in order to achieve reciprocal automatic exchange of information, in the form of bilateral agreements providing for measures equal to those in the EU Savings Directive.

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