

Savings Directive update February 18, 2010

Proposal for a Council Directive amending Directive 2003/48/EC on taxation of savings income in the form of interest payments

On September 15, 2008, the EU commission issued its report on the functioning of the Directive as required by Article 18 of the Directive. Further to this report, the EU Commission proposed amendments to the EU Savings Directive on November 13, 2008. Within the discussion process, the Council issued a “compromise text” on July 22, 2009. The text was amended on November 25, 2009.

This text takes into account most of the amendments proposed in the Commission’s draft. The ultimate aim of the proposal is to ensure (i) the effective taxation of interest payments which may be challenged by the use of intermediate tax-exempt structures or by the use of economic operators established outside the territorial scope of the EU Savings Directive, (ii) that the scope of the EU Savings Directive is extended to income equivalent to interest derived by some innovative financial products, and (iii) a level playing field between all investment funds or schemes, independently of their legal form.

The main amendments are the following:

1. A more precise definition of beneficial ownership

The scope of the EU Savings Directive will be extended to all interest payments made to non-EU based “entities”, whether or not they have legal personality, “legal arrangements” (e.g. foundations) and trusts, whose beneficial owner is an EU resident individual, by applying the so-called “look through approach”.

Lists of entities/legal arrangements are provided for information purposes in the Annex to the draft Directive and include the Delaware LLC and the Cayman trust.

The Council’s proposal specifies that entities and legal arrangements, which are de facto not “subject to effective taxation”¹, should apply the provisions of the EU Savings Directive upon receipt of any interest payment from any upstream economic operator. Entities or legal arrangements, which are subject to a general scheme of zero rate taxation (provided for in their tax law system) are not deemed to be subject to effective taxation.

The draft proposal provides a definition of the “place of effective management” of entities with or without legal personality. Accordingly, the place of effective management will be the place where most of the key management decisions (relating to assets producing interest payments) are taken.

2. Paying agent obligations

Since the paying agent is any “economic operator”, this concept has been taken to mean a credit or financial institution or any other natural or legal person, who on a regular basis or occasionally makes or secures interest payments within the meaning of the Directive. Now that additional information has been provided on the concept of

¹ “subject to effective taxation” shall mean that an entity or a legal arrangement is liable to tax on all its income, or on the part of its income attributable to its non-resident participants, including on any interest payment.

Paying agents are required to comply with exchange of information requirements, which have been described in detail, especially with regard to payments made to legal arrangements within and outside the territorial scope of the Directive.

If an EU economic operator makes a payment to a second economic operator outside the territorial scope of the Directive, the first economic operator might also be considered to be a paying agent. This is the case, if there is reason to believe that on the basis of the available information, the second economic operator will pay interest to an individual resident in another EU Member State.

The paying agent shall take reasonable steps to establish the identity of the beneficial owner, if the paying agent has information suggesting that the individual receiving an interest payment may not be the beneficial owner.

The beneficial owner may present a certificate of tax residency in a country different from the country of issuance of his/her passport/identity card. The certificate should be issued within the last three years before the interest payment date. To reduce the additional burden put on the tax authorities of the State of the paying agent, the certificate procedure was meant to be abolished in the EU Savings Directive draft of November 13, 2008, but was finally maintained in the new draft of November 25, 2009.

3. Extension of the scope of interest payments

Currently, only Undertakings for Collective Investments in Transferable Securities (“UCITS”) are deemed to pay qualifying interest. Some non-UCITS are also able to opt to be treated as UCITS for the purposes of the EU Savings Directive. The amendments to the EU Savings Directive extend the definition of qualifying interest paid by funds to interest paid by non-UCITS.

All securities that are equivalent to debt claims shall be covered by the amendment. The new definition covers:

- any income paid or realised relating to securities that entitle the investor to a return of at least 95% of the capital invested;
- any income paid or realised relating to securities which are linked to interest payments representing at least 95% of the total income derived from these securities since their issuing date (e.g. certificates linked to a basket of bonds or units in investment funds);
- benefits derived from some life insurance contracts which do not provide for a pension or a fixed amount annually paid to the policy holder for at least five years, if performance of the contract is linked to more than 40% of the interest income or income of all kinds. Under these conditions, any repayment before maturity of the life insurance, as well as any excess payment shall also be considered to be interest.

The Council's proposal also provides a detailed description of the classification method (already used in practice) determining the threshold of investment funds. The percentage of classification threshold shall be determined by reference to the investment policy, or the investment strategy and objectives laid down in the documentation governing the investment operations (e.g. fund rules, instruments of incorporation, agreements or legal documentation, any prospectus or similar documents). Where this documentation does not provide this information, the percentage shall be determined by the "actual composition of the assets"².

Where a paying agent has no information regarding the percentage of qualifying investments, the percentage is presumed to be above 40%. Please note that the redemption threshold will decrease to 25% as from January 1, 2011.

The Council's proposal excludes hedge funds that fall within the 40% threshold only because of collateral to which the investor is not a party and has no legal right.

4. Entry into force

Should the Council's draft proposal enter into force retroactively to 2009, the measures will be applicable as of January 1, 2012. The current draft requires Member States to amend their national implementation laws of the EU Savings Directive by January 1, 2011.

² The composition of the assets should be determined at the beginning, or at the date of the semi-annual report, and at the end of their last accounting period before the "interest payment". The financial products issued before July 1, 2010 should not be considered for the threshold valuation.

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