A CRITICAL ASSESSMENT OF THE PROPOSED DIRECTIVE ON TAXATION OF CROSS-BORDER SAVINGS INCOME

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Introduction

The Treaty of Rome[2] imposes a clear legal obligation on the Member States of the EU to remove all barriers to cross border movements of financial capital.[3] There is, however, no corresponding obligation imposed on the EU Member States to harmonise their tax laws relating to taxation of income from that capital, such as interests, dividends, royalties, etc. As a result, an undesirable legal situation has developed within the EU financial market where the free movement of capital is governed by EU law whereas taxation of income from that capital is subject to diverse and often conflicting national tax laws.

The adoption of Directive 88/361/EEC[4] on 1st July 1990 dismantled all barriers to create a level playing field for the free flow of capital within the European financial market. The mobility of capital within the EU borders was further accelerated by the adoption of a series of secondary legislation in the field of banking,[5] insurance[6]

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2 It was signed in Rome on 25th March 1957 and came into force on 1st January 1958.

3 Art 56-60 EC Treaty.

4 Directive 88/361/EEC for the implementation of Article 67 of the EEC Treaty, [1988] OJ L178/1.

5 Directive 2000/12/EC of 20th March 2000.

6 There are three generations of directives in the life and non-life insurance sector but it is sufficient in this context to mention the Third Life Directive 92/96/EEC [10th December 1992] and Third Non-Life Directive 92/49/EEC [OJ 1992, L228/1].

and investment services.[7]

The negative effect of this favourable financial environment is that it has also facilitated cross border capital flight to more attractive tax jurisdictions.[8] The problem of capital flight based on tax considerations has assumed even greater significance since the launching of the euro as the single currency of the majority of the Member States of the EU on 1st January 2002. The aim of this article is to examine the Commission proposal to the Council to adopt a directive to ensure taxation of cross-border savings income (the 'Savings Directive').

Legal Basis for Harmonisation of Direct Taxation

There is no specific provision in the Treaty of Rome which provides for harmonisation of direct taxation. The subsequent Treaty amendments such as the Single European Act,[9] the Maastricht Treaty on European Union,[10] the Amsterdam Treaty[11] and the Nice Treaty[12] (which is awaiting ratification), do not explicitly deal with this issue. The EU Treaties do not provide a mechanism to move towards tax co-ordination or harmonisation among the Member States. Rather than making progress towards converging the tax systems of the Member States, Article 58(1) of the Maastricht Treaty explicitly confers supremacy on national tax laws over Community freedom to move capital across internal borders.[13]

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7 Directive 93/22 on investment services in the securities field, OJ [1993] L 141/127.

8 For example, according to Swedish tax authorities, about SEK 350 billion are kept outside the country to avoid payment of tax on capital income. In Germany, bank managers are suspected of physically moving large sums of their clients money to be deposited in Luxembourg banks where they could receive interest on capital tax free.

9 This Act was signed on 17th February 1986 and came into force on 1st July 1987.

10 This was signed on 7th February 1992 and came into force on 1st November 1993.

11 The Amsterdam Treaty came into force in May 1999.

12 The Nice Treaty was approved by the Conference of Representatives of the Governments of the Member States in Nice on 9th December 2000 and needs to be ratified by all Member States according to their constitutional requirements.

13 This is reiterated in Recital 3 of the Savings Directive.

There are however certain Treaty provisions which may be indirectly invoked for the purpose of harmonisation of direct taxation.[14] For example Article 100 of the Maastricht Treaty (which was renumbered as Article 94 by the Amsterdam Treaty) directs the Council to adopt measures by way of unanimous voting to take appropriate measures to approximate the 'law, regulation or administrative action in Member States which have as their object the establishment or functioning of the internal market'.

As an exception to the unanimity of voting rule in Article 94, Article 95(1) provides for co-decision procedure to adopt laws which have as their objective the establishment of the internal market.[15] The invocation of this legal provision to harmonise the EU tax system could be justified on the basis of the Treaty objective to ensure harmonious development of its internal market. The differences in national laws on the taxation of income is liable to distort the smooth flow of capital within the EU and thereby offend the Treaty objective to develop a dynamic and stable internal market. It may be argued that such laws should be approximated to ensure the proper functioning of the internal market. However Article 95(2) excludes the application of co-decision procedure to fiscal matters. The effect of this qualification is that unanimity among Member States will continue to be an essential factor in order to legislate in the field of direct taxation.

Past Initiatives Towards Tax Harmonisation

Even though the EU Treaties do not provide a proper legal basis for tax harmonisation, certain efforts were made by the Community to achieve this goal.[16] It is useful briefly to examine those past initiatives to highlight the difficulties confronted by the EU in reaching a compromise on this politically sensitive issue. As highlighted below, there is also no guarantee that the current efforts to adopt legal measures to ensure taxation of cross-border savings income would succeed. Reflecting on the past experience towards tax harmonisation would thus be a useful exercise.

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14 Art 220 EC for example declares that double taxation should be avoided within the Community.

15 Art 251 EC provides for co-decision procedure to adopt a directive.

16 For example the European Commission appointed the Ruding Committee to investigate and report on various fiscal issues in the framework of the post-1992 consolidation of the internal market.

Article 6(5) of Directive 88/361/EEC provides that Member States shall adopt measures to harmonise tax laws relating to the taxation of capital income.[17] For this purpose, the European Commission submitted two proposals for consideration by the Council.[18]

The first proposal was to introduce a minimum withholding tax on interest received from the investment of capital. The Commission proposed the imposition of a levy of at least 15 per cent so as to ensure the payment of a minimum tax on interest. It was thought that by adopting a common withholding tax rate applicable to interest income of domestic and foreign investors alike, the temptation to place money in another EU country would be reduced or disappear.

Most of the Member States were not in favour of the Commission's proposal.[19] They had different reasons for opposing the idea of harmonisation of direct taxation. For example, the Netherlands wished to safeguard its role as an attractive location for holding companies[20] and Luxembourg strongly opposed the proposal arguing that an EU-wide withholding tax would lead to capital flights to other OECD countries.[21] Diverse national interests aimed at preserving their own tax laws coupled with the requirement of unanimous voting prescribed by Article 6(5) of Directive 88/361/EEC struck a fatal blow to the Commission's proposal.

Since unanimity was required in Council to adopt any legal measures on tax harmonisation, the Commission withdrew its proposal. The Commission thereafter explored the possibilities for closer co-operation and mutual assistance between the national tax administrations to prevent tax evasion. The problem with the proposal for exchange of information was that some Member States have strict bank secrecy

17 Art 6(5) envisages that the Commission will have submitted a proposal to the Council by 31st December 1988 on this matter and the Council was to take a position on this proposal by 30 June 1989.

18 [1989] OJ C 141/1, 7.6.1989 and COM[1989]90-2 final.

19 See Sideek Mohamed, 'National tax laws reign supreme over capital freedom', [1995] 2 EFSL 180.

20 For example, the Netherlands tax authorities do not tax income remitted to a Dutch parent company from a foreign subsidiary.

21 The financial sector in Luxembourg employs several thousands of people and generates about fifteen per cent of its gross domestic product. It does not impose a withholding tax on interest paid for money deposited by foreigners in Luxembourg bank accounts.

rules which they were not prepared to abolish.[22] Thus the second approach of the Commission also ended up as a futile exercise.

Current Initiatives Towards Tax Harmonisation

The problem of tax evasion linked to capital movements and the need to counter this problem at the EU level has resurfaced since the introduction of the euro as the single currency of twelve Member States. Even though the euro had been the official currency of 'euroland'[23] since 1999, for practical reasons the physical bank notes and coins were introduced only on 1st January 2002.[24]

Since the introduction of the euro, there can be no currency fluctuations or exchange rate differentials within the euro zone. Even though the liberalisation of capital movements in 1990 facilitated an outflow of money into countries having liberal tax regimes, there were also risks and costs involved in exchanging one currency for another within the EU. Such currency transaction risks and costs disappeared after the introduction of the euro. The risk of capital flight based on tax considerations is therefore much higher since the appearance of the physical euro bank notes. In view of this development, the Member States agreed in principle to soften their opposition to the adoption of measures to prevent harmful tax competition within its financial market.

There are two noteworthy initiatives taken by the EU to deal with cross-border taxation of savings income. The first initiative taken by the Commission in 1997 to adopt a directive to achieve this goal had to be withdrawn due to lack of support in the Council. A second proposal is now pending. It is useful to refer briefly to the first initiative and thereafter to examine in detail the objectives and the essential features of the second proposal to adopt a directive to facilitate taxation of cross-border savings income.

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22 France has very strict rules on tax declarations and the tax authorities have access to the central database and can collect information about all bank accounts. Luxembourg on the other hand has strict bank secrecy rules and will not divulge any information about its clients to any foreign tax authorities.

23 It is an expression used to identify the EU Member States which have adopted the euro as their single currency. The countries remaining outside the euroland are Denmark, Sweden and the UK. On 9th January 2002, the Swedish government announced it would call for a referendum on joining the euroland in 2003, link its currency, the Swedish kronor to the exchange rate mechanism in 2004 and to adopt the Euro by 1st January 2006.

24 A transitional period of three years was considered necessary to print, mint and put into circulation 14.5 billion euro bank notes and 50 billion coins in twelve euroland countries.

The first initiative taken by the Commission was on 5th November 1997 when it issued a communication to tackle harmful tax competition in the EU.[25] The Commission stressed the need for co-ordinated action at the European level to tackle harmful tax competition as a means to reduce distortions in the internal market, prevent excessive losses of tax revenue and to encourage tax systems to develop in a more employment-friendly way.

At the ECOFIN Council meeting of 1st December 1997, the Council examined the communication of the Commission and approved a text on the taxation of savings as a basis for a directive in this field. On the basis of conclusions of this meeting, the Commission presented a proposal for a Directive to ensure a minimum basis of effective taxation of savings income in the form of interest payments within the EU.[26] The European Parliament issued its Opinion on this proposal on 10th February 1999[27] and the Economic and Social Committee issued its Opinion on 24th February 1999.[28]

The Commission proposal based on the ECOFIN conclusions of 1st December 1997,[29] provides a compromise solution known as the 'co-existence model' to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community According to this proposal (hereinafter referred to as the Co-existence Model Directive), each Member State had the option to choose between applying a withholding tax on interest payments made to individuals resident in other Member States or to provide information to the beneficial owner's Member State of residence.[30]

Recital 22 of the Co-existence Model Directive declares that EU must enter into negotiations with its third country commercial partners, either on a bilateral or on a multilateral basis in order to ensure the effective taxation of income from savings covered by this Directive. A similar sentiment is expressed in Article 11 which provides that the Community shall enter into negotiations with the USA and other third countries for a similar purpose. This Directive was to be adopted from 1st

25 COM[1997] 564 final, 5.11.1997.

26 [1998] OJ C 212, 8.7.1998, p.13.

27 [1999] OJ C 150, 28.5.1999, p.184.

28 [1999] OJ C 116, 28.4.1999, p.18.

29 [1998] OJ C 2, 6.1.1998, p.1.

30 Recital 9 of the Co-existence Model Directive declares that its scope is limited to interest from investment of capital.

January 2001.

The Commission proposal for the adoption of the Co-existence Model Directive however received a hostile reception in the Council. Most of the Member States did not favour the idea of tax harmonisation at EU level. There are several reasons for Member States to oppose a proposal for tax harmonisation. The objections raised by the Member States to the adoption of a similar directive following the adoption of Directive 88/361/EEC were echoed again against the adoption of the Co-existence Model Directive. Another reason for the objections was that after the establishment of the European Central Bank, Member States in euroland completely lost their competence in the field of monetary policy.[31] It was no longer possible for Member States to unilaterally manipulate their monetary policy to suit the needs and demands of their local economies. The only instrument available for this purpose was a resort to fiscal measures and the Member States are therefore reluctant to surrender this competence.

The deadlock in the Council on the question of the adoption of legal measures to tax income derived from cross-border savings was to some extent resolved at the Santa Maria da Feira European Council on 19/20th June, 2000.[32] The Member States agreed to abandon the co-existence model in favour of a system of exchange of information on tax matters. In view of the new position taken by the European Council, the Commission withdrew its proposal for a Co-existence Model Directive and presented the second proposal for a Savings Income Directive[33] (the 'Savings Directive'). The new proposal builds on the consensus reached at the Santa Maria da Feira summit and the subsequent ECOFIN Council of 26th and 27th November 2000.

The Savings Directive will be adopted in accordance with the principle of subsidiarity set out in Article 5 of the EC Treaty.[34] In accordance with the spirit of this Treaty provision, the Directive must confine itself to the minimum required in order to achieve those objectives and not to go beyond what is necessary for that purpose. Member States are required to adopt the provisions of the Directive by 1st January 2004.[35]

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31 Art 105-111 of the EC Treaty.

32 Annex IV to the Presidency Conclusions of the Santa Maria da Feira European Council of 19th/20th June 2000, Press Release 200/1/00, 19.6.2000.

33 COM [2001] 400 final, 18.7.2001.

34 Recital 12 of the Savings Directive.

35 Art 18 of the Savings Directive.

The aim of this Directive is to ensure that cross-border savings income in the form of interest payments are subject to taxation in the Member State of residence of the taxpayer in accordance with its national laws. The scope of this Directive is limited to interest payments made by a paying agent established in one Member State to beneficial owners who are individuals resident in another Member State. The Directive does not deal with problems relating to the taxation of pensions and insurance benefits, which shall be the subject of separate legislative initiatives.

Essential Features of the Savings Directive

The Savings Directive is divided into four chapters and consists of 21 articles. The first chapter sets out the aims of the Directive and deals with issues of definition. The second chapter provides a mechanism for exchange of information on tax matters and the third and fourth chapters deal with transitional and miscellaneous issues respectively. It will be useful to highlight the essential features in the proposed Directive and then to comment on them critically.

Beneficial Owner

The Directive defines a beneficial owner as any individual who receives an interest payment for his own benefit.[36] A person who acts as a paying agent or acts on behalf of a legal person or an entity which is taxed on its profits under the general arrangements for business taxation or acts on behalf of another individual who is the beneficial owner are excluded from this definition.

The Directive requires Member States to lay down detailed rules for verifying the beneficial owner's current permanent address.[37] There are several methods to verify the address under the national rules. Such information could be verified for example by reference to the voters roll, making a credit reference agency search, local authority tax bill, bank, building society statement or checking a local telephone directory, etc.

In the case of individuals holding a passport issued by a Member State who declare themselves to be resident in a third country, residence is to be established by means of a residence certificate issued by the competent authority of the third country in which the individual claims to be resident. In all other cases, the place of residence

36 Art 2 of the Savings Directive.

37 Art 3 of the Savings Directive.

is to be considered the country where the beneficial owner's permanent address is situated.

Even in Member States that have implemented the transitional system, the Savings Directive provides that individuals can voluntarily request to be subject to the exchange of information system.[38] At the request of the beneficial owner, the competent authority of the Member State in which he resides is to issue a certificate indicating the name, address and tax or other identification number of the beneficial owner as well as the name and address of the paying agent. Such a certificate is to be valid for a period of three years provided the information in respect of which it was issued remains unchanged. The tax certificate shall be issued to any beneficial owner who has requested it within two months following such request.

The withholding tax levied by the Member State of the paying agent does not discharge the beneficial owner's tax liability in his country of residence. The Member State of residence remains fully entitled to tax the income received by the beneficial owner in accordance with its national laws. It is however obliged to eliminate any double taxation which might result from the imposition of the withholding tax by the Member State of the paying agent.[39] It is to avoid an individual being subject to double taxation that the Directive allows a beneficial owner the right to apply for a tax clearance certificate if he is resident in a Member State which applies the withholding tax.

Paying Agent

The paying agents are expected to play a key role in the implementation of the Savings Directive. The Directive defines a paying agent as any economic operator who pays interest directly or secures the payment of interest for the immediate benefit of the beneficial owner.[40] In keeping with the principle of subsidiarity, the Directive specifies the minimum amount of information which the paying agent has to report to its Member State of establishment. The Directive allows the Member States, if they so wish, to impose further reporting requirements on paying agents established in their territory.

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[38] Art 13 (2) of the Savings Directive.

[39] Art 14 of the Savings Directive.

[40] Art 4 of the Savings Directive.

Generally it is the traditional financial institutions which act as paying agents to the beneficial owners of the income derived from capital.[41] Paying agents are charged with providing information and, in the case of Member States which retain a withholding tax system, they are to deduct the tax on interest payments to individuals. The proposed Directive provides that Member States must take measures to ensure that paying agents established within their territory perform the tasks which have been assigned to them for the purpose of implementing the Directive.

An important obligation imposed on a paying agent is that they should strictly comply with the identification and reporting requirements of the Directive. They must establish the identity and residence of the beneficial owners in accordance with the minimum procedures laid down in the Directive. Paying agents have a legal duty to report the interest payments they make to individuals to the tax authorities of their Member State of establishment. The report should be comprehensive and include the name, address and the total amount of interest paid to the beneficial owner.

The Savings Directive provides that as regards their existing client base, paying agents should be able to rely as much as possible on information collected for other purposes. For contractual relations entered into after the date of implementation of the Directive, the identity shall consist of the name, address and tax or other identification number of the beneficial owner.

The duty imposed by the Savings Directive on paying agents to identify their clients' financial transactions is not an innovation. For example, Directive 91/308/EEC on the prevention of the use of the financial system for the purposes of money laundering[42] imposes a legal obligation on financial institutions operating in the EU to establish the identity of their regular clients under the so-called 'know-your-customer' rules. The Commentary to the Savings Directive presented by the Commission declares that for contractual relations entered into before 1st January 2001 the paying agent shall establish the residence of the beneficial owner by using the information it already has at its disposal, in particular pursuant to the oney Laundering Directive.

The Money Laundering Directive requires financial firms to keep appropriate records and establish anti-money laundering programmes. The Directive also requires banking secrecy rules to be suspended whenever necessary and any suspicion of

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41 For example in Sweden, financial institutions act as paying agents and they are legally bound to transfer directly to the tax office the capital income tax withheld from its customers.

42 [1991] OJ L 166, 28.6.1991, p.77.

money laundering to be reported to the authorities.[43] The definition of financial institutions in the Directive is based on the annex to the Second Banking Directive.[44] In transposing the Directive into national law, Member States are given competence to extend the scope of this definition.[45]

Similarly with the Savings Directive, the Money Laundering Directive itself is a product of compromise.[46] It sets out only the minimum rules necessary to combat money laundering and confers a large degree of discretion on the Member States to transpose the Directive even more strictly into domestic law. Since the Directive defines a financial institution by reference to the annex to the Second Banking Directive, it creates uncertainty as to its precise coverage. For example, the Investment Services Directive 93/22/EEC was adopted in 1993 and came into force on 1st January 1996 whereas the Money Laundering Directive came into force on 1st January 1993. It is therefore unlikely that the definition of financial institution in the Money Laundering Directive would include investment firms as defined in the Investment Services Directive. The reference to the Money Laundering Directive in the Savings Directive as a sufficient basis for customer identification is neither convincing nor adequate. The shortcomings in the Money Laundering Directive however will be rectified by an amending Directive in due course.[47]

Interest Payments

The definition of the scope of debt claims covered by the Savings Directive follows the definition of interest in Article 11(3) of the OECD Model Tax Convention on Income and on Capital.[48] There are different kinds of interest payments which are

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43 If a customer seek to deposit or transfer a sum of money exceeding €15,000, it is the duty of bank officers to carefully verify the legitimacy of such transactions. If it is a suspicious transaction, the bank should immediately inform the relevant authorities.

44 Art 1 of the Money Laundering Directive.

45 For example when Sweden transposed the Money Laundering Directive into its national law books, it included *bureaux de change* within the definition of a financial institution.

46 On money laundering in the EU, see Sideek Mohamed, 'Public Policy Limits Capital Movements in the European Common Market'[1995] 6 EBLR 262.

47 The European Parliament and the Council have agreed on the Commission proposal for a Directive to amend Directive 91/308/EEC [Document 599PC0352].

48 See OECD updated loose-leaf; condensed version 1996.

covered by the Savings Directive.[49]

The Directive covers cash deposits and security in the form of money. It also includes all types of corporate and governments bonds and debentures and similar negotiable debt securities. The Directive excludes penalty charges for late payments within the definition of interest payments.

The Directive also extends the definition of interest payment to income distributed by UCITS within the meaning of Directive 85/611/EEC[50] and undertakings for collective investment established outside the EU.[51] The adoption of the UCITS Directive opened the way for investment in unit trusts throughout the EU. A unit trust is a means whereby an investor can spread a limited investment over a wide variety of investments.[52] The unit trust could be a general fund investing in all EU companies or it could concentrate only on identified companies. It could also invest in bonds and securities. The reference to the UCITS Directive is to ensure that savings income received indirectly via investments in unit trusts is also included in the scope of the Savings Directive.

The income realised on the sale of shares in undertakings for collective investment in transferable securities is covered by the Savings Directive if those undertakings had directly or indirectly invested more than forty per cent of their assets in debt claims.[53] If an undertaking or entity meets the forty per cent threshold, the entire income will be considered an interest payment within the meaning of Article 6 of the Savings Directive. At the end of the transitional seven-year period, the forty per cent threshold is to be lowered to fifteen per cent. Member States would have the option of excluding income distributed by undertakings for collective investment which have invested less than fifteen per cent of their portfolio in debt claims from the definition of interest.

Article 6(6) of the Savings Directive contains a so-called de minimis rule which gives Member States the option to exclude income received from UCITS from the definition of interest payment. If a Member State exercises this option with respect to UCITS established within its territory, this choice will be binding on other

49 Art 6 of the Savings Directive.

50 [1985] OJ L375/3, 31.12.1985.

51 Art 6(c) of the Savings Directive.

52 Unit trust is the UK terminology and in the US they are referred to as mutual funds. In the EU context, they are referred to as UCITS.

53 Art 6(1)(d) of the Savings Directive.

Member States and they cannot require paying agents established within their territories to provide information or levy withholding tax on such income.

Exchange of information

An essential feature in the proposed Savings Directive is that it provides for exchange of information between tax authorities of the Member States. The aim of this provision is to ensure that EU residents pay the tax due on all their savings income derived in another Member State. The Directive sets out the minimum amount of information which should be reported by the paying agent to the competent authority of its Member State of establishment.[54] The information consists of the identity and residence of the beneficial owner, the name and address of the paying agent and the account number of the beneficial owner. The Directive provides that the communication of information must be automatic and take place at least once a year, within 6 months following the end of the tax year of the Member State of the paying agent.[55]

The UK is one of the first Member States to pass a law in relation to this information exchange system. It provides that the tax authorities shall report interest paid to 'non-residents' who are resident in a reportable country with effect from 6th April 2001. The national rule requires banks to pass all such information to the UK tax authorities which in turn may pass the information to the reportable country.

A Member State which opts to withhold tax will not be required to supply information concerning payments within its jurisdiction to individual residents in other EU countries. This does not prevent it from receiving information on income receipts of individual residents within its jurisdiction paid out of non-withholding EU Member States.

There are bilateral agreements which also provide a platform to cooperate and exchange information on payment of cross-border interest on savings.[56] In addition to bilateral agreements, there are also other tax treaties which include a clause providing for exchange of information.[57]

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54 Art 8 of the Savings Directive.

55 Art 9 of the Savings Directive.

56 For example USA has bilateral information exchange agreements with a number of countries in Latin America and the Caribbean.

57 Most of the tax treaties which has incorporated a provision on information system is based on Art 26 of the OECD Model Tax Convention.

In this context, it is useful and relevant briefly to examine the scope of application of Directive 77/799/EEC concerning mutual assistance by the competent authorities in the field of direct and indirect taxation.[58] The aim of the Mutual Assistance Directive is to focus on correct assessment of tax and prevention of tax evasion and avoidance.[59] The kind of information system established under the Mutual Assistance Directive may however prove to be insufficient to ensure an effective system of taxation of cross-border savings income within the EU financial market.

There are certain limitations inherent in the Mutual Assistance Directive. Article 2 provides that one Member State may request that another Member State forward particular tax information. The Member State receiving the request has the right not to comply with the request if the Member State making the request has not exhausted its own usual sources of information. A Member State can also, on giving reasons for its refusal, refuse to furnish the requested information.[60]

Article 8 of the Mutual Assistance Directive sets out a series of limitations on the exchange of information between the Member States. It excludes a State from the duty to exchange information if it is prevented by its laws or administrative practices from carrying out such inquiries or from collecting or employing such information for its own use. The obligation to disclose is also lifted if disclosure would be of a commercial, industrial or professional secret or would be contrary to public policy. A Member State is not under an obligation to exchange information if there are practical or legal reasons to provide such information. The effect of these exceptions is that certain Member States will not be legally competent to exchange information on savings interest. These limitations have been addressed and rectified in the Savings Directive.[61]

The Mutual Assistance Directive does not include common rules concerning the details of the information to be reported, the format and frequency of the information exchanges, and the mechanisms to carry out the information exchange. As a result, even when information is exchanged between the authorities of different Member States, it may not be in usable form. Unlike the Mutual Assistance Directive, the Savings Directive establishes a clear and comprehensive information system between Member States to ensure the effective taxation of cross-border savings income in the form of interest payments. The application of Article 8 of the Mutual Assistance

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58 [1977] OJ L 336, 27.12.1977, p.15.

59 Art 1 of the Mutual Assistance Directive.

60 Art 5 of the Mutual Assistance Directive.

61 See Art 9(3).

Directive is expressly excluded in relation to the information which must be communicated under the proposed Directive.[62] The Mutual Assistance Directive itself provides a legal basis for such an exclusion if its provisions would impede the fulfilment of any obligation to exchange information which might flow from other legal acts.[63]

Derogations From the Duty to Exchange Information

There are some Member States which are not prepared to exchange information with other Member States on tax matters. These Member States are given a transitional period during which they shall apply withholding tax to income derived by non-residents.[64] The Directive requires those Member States levying a withholding tax to transfer a certain percentage of the revenue to the investor's state of residence.

The countries which are given this special temporary status are Austria, Belgium and Luxembourg. These countries can maintain their banking secrecy regimes for a fixed period of time. During the interim period, they are required to impose a withholding tax on non-resident savings income. Even though they are not required to exchange information, the Directive mandates such Member States to receive such information from the other Member States. The Member States with a special derogation are to implement the information system within seven years of the entry into force of the proposed Savings Directive.

The Savings Directive lays down the amount of withholding tax that can be levied by such Member States and prescribes the procedure to divide the tax collected between the relevant Member States. The rate of taxation is set at fifteen per cent. for the first three years and twenty per cent. for the balance of four years.[65] A Member State which collects the withholding tax is to retain twenty-five per cent. of the revenue and transfer the balance of seventy-five per cent. to the investor's state of residence.[66] In keeping with the principle of subsidiarity, Member States levying withholding tax are given the choice of selecting the most suitable practical arrangements to ensure the proper functioning of the revenue-sharing system.

[62] Art 9(3) of the Savings Directive.

[63] Art 11 of the Mutual Assistance Directive.

[64] Art 10 of the Savings Directive.

[65] Art 11 of the Savings Directive.

[66] Art 12 of the Savings Directive.

Exclusions from the Directive

There are a number of international organisations which under their articles of agreement are exempt from the obligation to deduct any withholding tax from interest payments made on debt claims that they have issued.[67] All Member States have signed and ratified the international agreements establishing the International Bank for Reconstruction and Development and the International Finance Corporation and most Member States are also members of other international organisations. The Savings Directive allows Member States to respect their international obligations by exempting paying agents acting on behalf of such organisations from the obligation to levy withholding tax.[68] This exemption is limited in scope as it only covers situations where the international organisation itself, or a paying agent it has appointed, pays interest directly to the beneficial owner.

The Savings Directive does not apply to income derived from the equities market. Investment in equities is the fastest-growing part of the international financial markets. With the low return on traditional savings accounts, there is a growing emphasis on stock market investments. There were various considerations which made it necessary to exclude this category of income from the scope of the Directive.[69] The Directive does not apply to resident savers or those living outside the EU.

There is a special grand-fathering clause which exempts domestic and international bonds and other negotiable debt securities issued before 1st March 2001 from the scope of the Directive.[70] The Directive however provides that if a further bond issue is made on or after 1st March 2001, payments in respect of the original issue and any further issue will come within the definition of interest payment in Article 6(1). The grand-fathering clause will not prevent a Member State from taxing the income from the negotiable debt securities.[71]

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67 These international organisations include the Inter-American Development Bank, the International Investment Corporation, the Asian Development Bank and the African Development Bank.

68 Art 16 of the Savings Directive.

69 In Germany for example there is a traditional preference for investing in bonds, and the country's 1992 withholding tax applies only to interest income. A majority of the €900 billion of funds in Luxembourg are invested in equities.

70 Art 15 of the Savings Directive. For e.g. in UK the international bond market is valued at around €3,000 billion.

71 Art 15(2) of the Savings Directive.

Article 1 of the Savings Directive declares that savings income in the form of interest payments made in one Member State to beneficial owners who are individuals resident in another Member State shall be subject to effective taxation. A literal interpretation would suggest that there must be an element of cross-border payment within the EU if a transaction is to be covered by the Savings Directive. If the paying agent and the beneficial owner are resident in one and the same Member State but the income is generated in another Member State, on the basis of this interpretation, such a transaction would fall outside the scope of the Directive.[72]

In a similar vein, a closer reading of Article 4 of the Savings Directive indicates that the paying agent should be situated within the EU if an interest payment made by such an entity is to be covered by this Directive. If the paying agent is located outside the EU but an investor resident in one Member State makes an investment in another Member State, income generated from such an investment would arguably fall outside the scope of the Directive.[73]

Distinction Between Retail and Institutional Investors

The Savings Directive makes a distinction between private 'retail' investors and institutional investors. The former are covered by the Directive while the latter are excluded. Consideration of the eurobond market is relevant in this context. Eurobonds are usually issued on the basis that interest payments are made without deduction of tax. Individual investors constitute only a small percentage of the investor base in the eurobond market.[74] The differential treatment of investors in the Savings Directive may have the effect of discriminating against small savers as against big investors. The special tax benefits granted exclusively to institutional investors in the Savings Directive would further confirm the criticism often made against the EU that the Single Market benefits companies and not individual consumers.[75]

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72 For example, if the paying agent and the beneficial owner are resident in Sweden but the income is derived from investments in Finland on government or corporate bonds, the transaction would be outside the scope of the Directive.

73 For e.g. if the paying agent is based in Switzerland, the beneficial owner is resident in Sweden and the income is derived from investments in Denmark on government or corporate bonds, such a transaction would be outside the scope of the Directive.

74 According to the International Primary Market Association, between five to seven per cent of bonds would be vulnerable to redemption if the Savings Directive were implemented.

75 See Sideek Mohamed, 'Consumer Protection in the EC Financial Market'[2001] 8 Consum.L.J.383.

Various arguments may be adduced in support of the exemption of interest payments made to companies from the scope of application of the Directive. In practice, the problem of individual tax evasion is more complex than in the company tax area. The company law legislation generally provides a legal mechanism to prevent tax evasion. Such national measures impose a legal obligation on companies to lodge comprehensive annual tax returns. The entities are also audited or are subject to the possibility of being audited on a regular basis. The main problem for tax administrations with regard to companies is not the issue of non-taxation of interest payments but tax avoidance through aggressive tax planning. This problem cannot be tackled within the framework of the Savings Directive but it should be addressed in separate EU legislation.

Whatever the justification may be for the exclusion of the institutional investors from the ambit of the Savings Directive, the distinction drawn between two categories of investors for similar tax purposes may come into conflict with the Treaty provisions on free movement and the principle of non-discrimination. There is no doubt that the inclusion of retail investors in the Savings Directive will discourage them from investing in bonds issued in another Member State. Such a limitation on investment opportunities would constitute an obstacle to the free movement of capital enunciated in Article 56 of the EC Treaty.

It is relevant in this context to refer to Article 58(1) EC which is an exception to Article 56 EC. The Savings Directive makes reference to this Treaty provision in its recitals.[76] This provision allows Member States to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested. However Article 58(2) EC declares that such measures and procedures shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments. There is one school of thought which takes the view that this exception may be interpreted as allowing Member States to continue with withholding taxes, provided they do not discriminate unjustifiably.[77] In view of the presence of Article 58(1) EC, the case law indicates that the European Court prefers to resolve issues relating to the compatibility of national measures with EC law by reference to the Treaty provisions on the right of establishment or services, even if the dispute could have been resolved by reference

[76] See Recitals 3 and 4 of the Savings Directive.

[77] See Philip Bentley, 'Tax Obstacles to the Free Movement of Capital', [1997] 2 *ECTJ* 49 at p.57.

to the chapter on capital movements.[78]

The case law makes it abundantly clear that the Court will not uphold any Treaty exceptions if it would have the effect of seriously impeding the exercise of a Community freedom. In *Commission v Belgium*[79] the Court had to examine the compatibility of a national law providing for differential treatment of retail and institutional investors for tax purposes with Articles 56 and 58 of the EC Treaty. The Court had to resolve various issues dealing with the free movement of capital and national restrictions on investments in the eurobond market.

The Belgian Minister of Finance had contracted a public loan of DEM 1,000 million on the eurobond market. The relevant Belgian law waived withholding tax on interest payable on the loan but this benefit was denied to Belgian residents. The exclusion did not apply to banks, financial intermediaries and institutional investors based in Belgium. The Belgian national measure is similar to the distinction made between retail and institutional investors for tax purposes in the Savings Directive. The Court declared that the 'prohibition' on Belgian residents subscribing to a loan issued abroad constituted a barrier to the free movement of capital.

The Belgian government sought to justify the exclusion on the grounds that, by denying natural persons resident in Belgium the opportunity to subscribe to the public loan issued in Deutsch marks, the measure prevented those persons from evading tax in Belgium by not declaring the interest received. The Court declared that the outright prohibition of the acquisition by Belgian residents of securities consisting of a loan on the eurobond market, thereby impairing the free movement of capital, was not proportionate to its aim to prevent tax evasion.[80] It is evident that the provisions of the Savings Directive are not compatible with this judgment.

Uncertainties Regarding the Adoption of the Savings Directive

There are certain conditions which should be satisfied for the adoption of the Savings Directive. The European Commission has to negotiate equivalent agreements on an

78 See on this point, Sideek Mohamed, 'A critical assessment of the ECJ judgement in Trummer and Mayer' [1999] 14 JIBFL 396 at 401.

79 Case C-478/98 [2000] CMLR 1111. For a more detailed discussion of this judgment, see Sideek Mohamed, 'Recent Case Law in the Field of Free Movement of Capital' [2001] 3 JIB Reg. 178.

80 For e.g. in Case C-28/95, *Leur-Bloem* [1997] ECR I-4161 at para 44, the Court of Justice declared that a general presumption of tax evasion or tax fraud could not justify a fiscal measure, which compromises the objectives of a Directive.

information system with a number of important non-EU financial centres before the end of 2002.[81] Another requirement is that about 66 measures of unfair corporate taxation identified in different Member States should be withdrawn before the adoption of the Savings Directive.[82]

The Savings Directive does not state expressly that the EU should secure equivalent agreements on an information system with third countries. This is in contrast with the Co-existence Model Directive which was more specific on this point.[83] However, the requirement of securing such an agreement with named third countries is clearly spelt out in the Conclusions of the Feira European Council as a precondition for the adoption of the Savings Directive. It was agreed at that summit that the Presidency and the Commission should enter into discussions with the US and key third countries to promote the adoption of equivalent measures in those countries.[84] It was also agreed that Member States concerned, such as the UK and the Netherlands, should commit themselves to promoting the adoption of the same measures in all relevant dependent or associated territories.[85] Once sufficient re-assurances with regard to the application of the same measures have obtained, the Council will decide on the adoption and implementation of the Savings Directive no later than 31st December 2002.

The success of the plan to adopt the Directive therefore remains in doubt. Evidently, an important pre-condition for the adoption of the Directive is that non-EU countries should also agree to exchange of information on savings held by non-residents. There is however no legal obligation on third countries to respect the EU law as it does not have extra-territorial application. There is no guarantee that third countries would comply with the EU demands to enter into an agreement to exchange

81 These include Switzerland, the US, Liechtenstein, Monaco, San Merino.

82 These tax measures were identified in a report of the *Primorolo Group* to the Commission. If these measures are not rolled-back by the end of 2002, Austria and Luxembourg are likely to take back their agreement to the proposed Savings Directive.

83 See Recital 22 and Art 11 of the Co-existence Model Directive.

84 Annex V of the Presidency Conclusions of the Santa Maria Da Feira European Council, 19 and 20th June 2000.

85 The named countries are the Channel Islands, Isle of Man, and the dependent or associated territories in the Caribbean. The Member States commitment to promote the adoption in these associated territories of the same measures that the Member States may adopt and implement under the Savings Directive was reiterated in a Decision of the Representatives of the Governments of the Member States meeting within the Council of 27th November 2001 concerning the taxation of savings in Caribbean dependent or associated territories ([2001] OJ L 314/78, 30.11.2001).

information on tax matters.[86]

There is another uncertainty which would remain until the final adoption of the proposed Savings Directive. The legal basis for the adoption of this Directive is Article 94 EC which provides for unanimity voting in the Council. In order to add more political weight to the law-making process prescribed in Article 94 EC, the requirement of unanimity voting to adopt the Savings Directive was specifically included in the agreement reached at the Feira Council meeting. Some Member States have reserved their right to veto the Savings Directive if the Community fail to secure similar agreements with third countries on an information exchange system. Luxembourg has postponed its approval of the Feira agreement until the adoption of an information system in the named key non-EU jurisdictions. Austria has to amend its constitution if it is to adopt the information system.

The fate of the Savings Directive does not only depend on the successful conclusion of negotiations with third countries on an information system on tax matters. At the Feira Council, it was agreed by all Member States that in addition to the Savings Directive, there are two other tax packages which should be introduced together as a single package to tackle harmful tax competition in the EU. The other two elements are a Code of Conduct for business taxation and a proposal for a Directive on interest and royalty payments between companies. This agreement to adopt a tax package was based on a Commission communication, which was discussed at length at the Verona ECOFIN meeting in April 1996 and subsequently at its informal meeting in Mondorf-les-Bains in September 1997.[87] A proposal for a Directive on interest and royalty payments between companies has been pending since 1990.[88] The Savings Directive will be adopted only if the other two elements are also adopted at the same time. However very little progress has been made so far in relation to the other two elements of the tax package.[89]

86 For example Switzerland reacted to this proposal and declared its opposition to exchange of information with tax authorities of EU Member States. Switzerland imposes thirty-five per cent withholding tax on dividend and interest income earned by Swiss residents on stocks and bonds of Swiss companies. It might consider extending that tax to foreign investors and even sharing tax revenues with the EU.

87 See the ECOFIN Council meeting on 1st December 1997 concerning taxation policy [98/C 2/01].

88 See the Proposal for a Directive on a Common System of Taxation applicable to Interest and Royalty Payments made under Parent Companies and Subsidiaries in different Member States ([6th December 1990][1991 OJ C53/26 amended by 1993 OJ C178/18]).

89 For example, the proposal for a Directive on interest and royalties is pending as far back as from 1990.

Concluding Remarks

The establishment of a European single market in financial services was facilitated by the liberalisation of the free movement of capital and the introduction of the euro as its single currency. Within this open and conducive financial environment, there are also vast opportunities for tax evasion and money laundering.

In order to ensure the effective taxation of cross-border savings income, the EU decided to adopt the Savings Directive. The aim of this Directive is to provide a legal basis for exchange of information between the tax authorities of the Member States so as to minimise or eradicate the problem of capital flights and tax evasion within the EU. By creating a proper legal framework for exchange of information between the Member States, the Directive seeks to prevent private investors from avoiding paying taxes by placing their savings abroad.

The Savings Directive does not seek to introduce a harmonised system of taxation of interest income within the EU. The proposal for a Co-existence Model Directive was withdrawn due to objections from different Member States as it was based partly on a system of harmonised withholding taxation. Their resistance to the introduction of withholding taxation remains almost intact. At the Feira summit, it was agreed that no derogation from the information system should be granted in enlargement negotiations with accession countries. This would imply that the candidate countries could not introduce or retain withholding taxation systems even as a transitional measure. This is another indication that the EU is not inclined to introduce a withholding taxation system.

A major criticism that may be levelled against the Savings Directive is the limited scope of its application. The Directive covers only cross-border savings income in the form of interest paid in one Member State to individuals who are resident in other Member States. It does not deal with interest income paid to residents of third countries or income derived from equity investments. The amount of tax that could be collected from savings income is insignificant compared to the income generated in the equities market. Even though the Savings Directive might reduce the incidence of tax avoidance, its contribution to increasing the volume of tax collection will be marginal.

The lack of qualified majority voting in tax matters is the main cause for the distortions in the EU tax systems. One of the reasons for the Council not agreeing on a more comprehensive piece of legislation to deal with taxation of cross-border capital income was the requirement for unanimity voting for its adoption. Until the Community move from unanimity to qualified majority voting in tax matters, the EU will have to live with half-baked tax legislation to deal with tax evasion and avoidance.[90]

Another criticism of the Directive is that it limits its application to retail investors. The rationale behind this may perhaps be an assumption that this category of investors are the worst tax offenders within the EU financial market. Since the Directive targets only this category of investors, a prudent and intelligent retail investor could find ways and means to avoid payment of tax on his cross-border savings income. Since Article 56 EC allows the freedom to move capital between the Member States and also to third countries,[91] retail investors could freely decide how and where to invest their capital resources. They could legally move their cash savings or bank deposits abroad and invest them in the equities market in a Member State which gives them generous tax benefits. Since the Savings Directive does not apply to income derived from investments in the equities market in another Member State, a retail investor could thereby evade the application of the Directive.

There are also possibilities for retail investors in the eurobond market to side-step the objectives of the Savings Directive with relative ease. The success of the eurobond market is due to less regulation and the tolerance of flexible contractual terms and conditions. An attraction of the eurobond market to international investments is the provision of generous tax incentives to investors. It is not uncommon for parties to a loan raised in the eurobond market to freely determine the nature of the terms and conditions of any proposed financial contract. It is possible for the parties to the contract to include a condition which provides for the issuer to maintain at least one paying agent in a non-EU country. Since the Savings Directive excludes interest income paid out by a paying agent established outside the EU, the presentation of a bond or coupon to a non-EU paying agent would exempt a retail investor from the scope of the Directive.

There is also another possibility for a retail investor to by-pass the objectives of the Savings Directive. There is no legal prohibition on an individual receiving interest payments through a nominee company set up either in his state of residence or in a non-EU country. Since interest payments to the company will be outside the scope of the Directive, an individual could by this means avoid the application of the Savings Directive. In view of these considerations, if the Directive is adopted in its current form, it could trigger massive capital flights abroad for investments in eurobonds and

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90 Some initiatives were taken for this purpose to be presented at the Nice summit but due to political objections, were not even placed on the Council agenda.

91 Joined Cases C-163, 165 and 250/94, *Sanz de Lera and Others* [1995] ECR 1-4821. See also Sideek Mohamed, 'Legal and Judicial Developments in the Field of Capital Movements', [1996] 7 EBLR 273-279.

equities.[92]

To sum up on a positive note, if the Savings Directive is fully implemented, it will effectively bring an end to banking secrecy within the EU. This should facilitate not only the stamping out of (or at least the minimising of) tax evasion but also contribute to the effective combatting of the crime of money laundering. Furthermore, if the euro becomes a success story, then it might pave the way towards a certain degree of tax harmonisation at least within euroland.

92 For example a Swedish resident can transfer his capital to Luxembourg and from there deal in the stock market in Stockholm via the internet and avoid paying tax as the Luxembourg tax authorities are not obliged under the Savings Directive to impose withholding tax on such income or to inform such income to their Swedish counterparts.