MEMO# 13777

July 31, 2001

NEW PROPOSAL BY THE COMMISSION OF THE EUROPEAN UNION ON THE TAXATION OF SAVINGS INCOME

[13777] July 31, 2001 TO: INTERNATIONAL COMMITTEE No. 47-01 TAX COMMITTEE No. 22-01 RE: NEW PROPOSAL BY THE COMMISSION OF THE EUROPEAN UNION ON THE TAXATION OF SAVINGS INCOME On July 18, 2001, the Commission of the European Union (EU) issued a new proposal for a directive on taxation of savings income to replace the Commission's 1998 proposal. The 1998 proposal generally was designed to provide a mechanism by which an EU member state that taxes savings income could collect that tax when its citizens purchase savings products in another member state. 1 After three years of intensive discussions regarding the original proposal, the member states have agreed to take a significantly different approach to the directive. As a result, the Commission has decided to withdraw its 1998 proposal and present a new proposal for a directive. Of particular significance to collective investment vehicles, the new proposal, in part, defines reportable payments under the directive to include income derived from interest that is distributed by a UCITS fund or an "undertaking for collective investment" established outside the European Union, including US mutual funds sold in the European Union. For this purpose, it is irrelevant whether the reportable income is from EU or non-EU sources, so long as the distribution is made by a "paying agent" within the European Union. This memorandum briefly describes the significant aspects of the new proposed directive. Obligation of EU Member States to Exchange Information Under the new proposal, a tax reporting obligation generally would arise whenever a paying agent within an EU member state makes interest payments to an individual resident in another EU member state or an individual redeems an interest-bearing security in another member state. As proposed, the member states would be required to implement exchange of information as soon as possible and, in any event, no later than seven years after entry into force of the directive ("transitional period"). During the transitional period, Belgium, Luxembourg, 1 The Commission issued its original proposal for a savings directive in May 1998. The original proposal for a directive was based on a compromise solution in which each member state had a choice between applying a withholding tax on interest payments made to non-residents or providing information to the beneficial owner's member state of residence. 2and Austria would be required, in lieu of exchanging information, to withhold tax at a rate of 15% for the first three years and at rate of 20% for the remainder of the period.2 The other member states would be required to communicate information automatically to these three member states without requiring reciprocity during the transition period. Scope of the Directive The directive would apply to interest payments made within the European Union, regardless of the jurisdiction in which the issuer of the debt is established. The scope of the directive is limited to an interest payment made by a paying agent established in one

member state to beneficial owners who are resident in another member state. Moreover, to be covered within the directive, the interest payments must be made to an individual or for his benefit; interest payments made for the benefit of companies or other legal persons are excluded from the scope of the directive. Under the proposed directive, an “interest payment” is defined broadly to cover interest from debt-claims of every kind, including cash deposits, corporate and government bonds, and other similar negotiable debt securities. Interest payments also would include interest accrued or capitalized at the sale, refund, or redemption of the debt instrument. The proposed directive would exempt bonds and other negotiable debt securities that have been issued before March 1, 2001, from the scope of the directive during the transitional period under certain conditions. This exemption would apply regardless of whether the paying agents are established in member states that would levy a withholding tax or exchange information. The Commission also proposes to include within the definition of “interest payments” (1) income derived from interest payments distributed by funds and (2) income realized upon the sale, refund, or redemption of shares or units in funds if they invest more than 40% of their assets in debt instruments (or more than 15% after the transitional period).3 With this definition, the proposed directive would apply to UCITS funds and funds established outside the European Union that have paying agents in the European Union. The proposed directive would provide member states the option to exclude from the definition of “interest payment” as described above income from UCITS funds “established within their territory” with portfolios that do not exceed 15% of investments in debt instruments. Member states exercising this option effectively would exclude UCITS equity funds from the coverage of the proposed directive. 2 The member states levying withholding tax must provide procedures to ensure that the beneficial owner may request that no tax be withheld. In addition, these member states would be required to transfer 75% of the revenue from the withholding tax to the member state of residence of the investor. 3 The percentage would be determined by reference to the investment policy of the funds and, if none exist, by reference to the actual composition of the assets of the funds. The directive also would apply to income distributed to UCITS funds and other non-EU funds (Tier I funds) by other UCITS funds or non-EU funds (Tier II funds) if the income is derived from interest payments or any income realized by the Tier I fund on the sale, refund, or redemption of shares in Tier II funds if the Tier II funds invested more than 40% of their assets in debt. 3Paying Agent The proposed directive specifies the minimum amount of information that a “paying agent” would be required to report to the member state in which the agent is established. The member states, in turn, would be required to communicate that information to the member state in which the beneficial owner is resident. The proposed directive would define a “paying agent” as an entity that pays interest to, or secures the payment of interest for the immediate benefit of, the beneficial owner. Moreover, certain EU entities (other than UCITS funds) would be considered paying agents upon receipt of interest for or on behalf of a beneficial owner. With this definition, the Commission intends to identify a single paying agent within a chain of intermediaries for purposes of imposing the obligations of the directive. Under the proposed directive, member states would be required to adopt and enforce procedures that would allow paying agents to identify beneficial owners and their residence for the purposes of the directive. The proposed directive would provide the minimum standards for establishing the identity and the residence of the beneficial owner. * * * The proposal will be forwarded to the Council of Ministers of the European Union. In conjunction with the discussion in the Council, the Presidency and the Commission will be engaging in discussions with third countries (i.e., the United States, Switzerland, Liechtenstein, Monaco, Andorra, and San Marino) to promote adoption of similar measures designed for the exchange of information regarding the savings income of non-residents. Certain member states also have committed to adopting the same measures in all of their territories (the

Channel Islands, Isle of Man, and the dependent or associated territories in the Caribbean). It is expected that the Council will decide upon the adoption of the directive only once there is assurance that third countries and member state territories will take a similar approach. Please let us know if you have any concerns about the proposal with respect to US mutual funds and/or UCITS funds. If you have any comments or questions regarding the effect of the proposal on US mutual funds, please contact Deanna Flores at (202) 371-5436 or at dflores@ici.org. If you have any comments or questions for UCITS funds, please contact Jennifer Choi at (202) 326-5810 or at jchoi@ici.org. Deanna J. Flores Jennifer S. Choi Associate Counsel Assistant Counsel Attachment 4Attachment (in .pdf format)