

## PROPOSED AMENDMENTS TO THE SAVINGS DIRECTIVE: KEY IMPLICATIONS FOR THE LUXEMBOURG FUND INDUSTRY

**The proposed amendments, if adopted, will have broad implications for the Luxembourg financial sector. In particular, the new Directive will have a significant impact on paying agents' reporting requirements. The scope will be amended with regard to "innovative" financial products, funds and insurance products. This article aims to comment on the proposed amendments and evaluate their impact on the Luxembourg investment management industry.**

### BACKGROUND

On 15 September 2008, the Commission presented the first formal report to the Council on the effectiveness of the Savings Directive following its first three years of application. The report was based on consultations with the Member States' tax administrations, data provided by them for the first two years of the application and findings of an expert group set up by the Commission to seek advice from the business sector. The document concluded that the Directive "is working within its scope".

### ECONOMIC IMPACT OF THE CURRENT DIRECTIVE

The report was accompanied by the Commission Staff Working Document that provides an evaluation of the economic effects of the Directive. It is worth noting that, based on the statistics contained in the working document, the Directive proved remarkably well implemented in Luxembourg. Luxembourg has levied a total of €166 million (Total of all EU, Luxembourg included: €259,7 million) in withholding tax in 2006 (the first year of full operation) and has shared 75% of that revenue

(€125 million) with other Member States. These figures correspond to total cross-border interest payments subject to withholding amounting to €1,107 million. In comparison, cross-border interest payments reported by Luxembourg in 2006 using information exchange amounted to €4,189 million (Total of all EU, Luxembourg included: €11,824 million).

Two interesting observations can be drawn from the preceding figures. First, despite numerous new obligations following the introduction of the Savings Directive, Luxembourg was able to collect and report accurate information about its economic impact (amount of withholding tax, interest payments under both the withholding tax method and the exchange of information method, number of beneficial owners, etc.). Quite surprisingly, several Member States which exclusively apply the exchange of information – and which should by definition be in possession of the information to be exchanged – were unable to provide the Commission with the relevant figures. Second, the amount of interest subject to withholding for 2006 (€1,106 million) appears to be quite low when compared to the amount of interest subject to information exchange (€4,188 million). This runs counter to a widely held idea according to which most interest payments made by Luxembourg paying agents are subject to withholding, hence potentially enabling beneficiaries of such payments to evade taxation in their state of residence.

### OBJECTIVES

Despite the apparent success of the Directive, the Commission indicated that its current coverage did not fully match the general ambitions. Therefore, the Commission has proposed to amend the Directive with the clear intention of closing possible loopholes and eliminating an uneven play-

ing field between economic operators. The Commission has stated that it wanted to achieve these objectives by limiting disproportionate administrative burdens and unnecessary costs for paying agents.

### EXTENDED DEFINITION OF INTEREST INCOME

Beyond the inclusion of interest payments on debt claims, directly or indirectly via UCITS, the definition of interest income is planned to be expanded to include income from innovative financial products, a wider range of funds and certain life insurance contracts. Innovative financial products that are covered by the proposal are those securities that entitle their beneficiaries to a return on capital whose conditions are defined at the issuing date and to a capital reimbursement of at least 95% on maturity. As regards life insurance contracts, it is now proposed to include all such contracts which benefits are fully derived from debt claims and which provide low (less than 5%) biometric risk coverage.

The proposed definition of interest payments for innovative products, although relatively easy to implement by the paying agents, is too broad, as its definition seems also to include capital market risk premium of any kind. It would indeed include all income derived from financial products where the conditions on return on capital are fixed in advance, regardless of whether those products are comparable to debt claims or rather reflect equity or similar characteristics. This would for example include income from stock index-tracking structured products with a capital guarantee of 95%, since the conditions of the return (the index performance) are fixed at the issuing date and the capital reimbursement would amount to 95% of the capital invested. However, such products do not derive

their returns from debt claims in any way. In fact, an investment in an index-tracking structured product can, at best, be assimilated to an investment in the stocks composing the index and as such should not be covered by the Directive. A more precise definition to cover actual Luxembourg practice and make sure only interest income is captured would be necessary.

As far as insurance products are concerned it has always been a requirement of the fund industry to make sure that the Commission ensures a level playing field. In the view of the European fund industry to achieve this goal, a change has to be made to the actual proposal. In order to qualify as a savings product a biometric risk of less than 5% would be required. In order to assess whether this measurement is sufficient, the Commission should research what the biometric risk levels are in the different Member States for qualification as an insurance product to make sure that the definition adopted by most EU members is reflected. In a second step if an insurance product is within the scope of the Directive its performance has to be fully linked to interest income to produce reportable amounts. It remains questionable whether this measure is comparable to the 40% rule applied on redemption from investment funds (25% from 1 January 2011).

In addition, income obtained through non-UCITS vehicles is also to be considered as interest income within the meaning of the new Directive. Again, the Commission's definition of interest seems very broad. As a matter of fact the Commission refers to collective investment fund or scheme registered in accordance with the rules of any Member States or any entity having opted for such treatment under article 4(3) (the paying agent upon receipt article). It appears that the Commission therefore proposes to include within the scope of the Directive investment funds which may have no connection either to public saving or the concept of EU cross border distribution, excluding vehicles operating exclusively in the internal markets. The statistics on Part II funds in Luxembourg have shown growth figures which are in line with UCITS i.e. no market distortion has been evidenced. It is

true that some of these funds have been distributed cross border. One could ask the question whether the next step should be to limit the inclusion to the domestic funds that have authorisation for cross border distribution. Another angle could be to include only those funds that are UCITS-like albeit it would be a major challenge to define what constitutes "UCITS-like". In addition, the definition of schemes and funds "registered" might suggest a marketing incentive to unregulated vehicles which seems highly counter productive given the actual financial market crisis. Moreover, it would be important to benchmark certain funds with publicly listed investment companies or trusts which could have very similar activities.

While it can be defended that the extension of the scope brings additional cost to the industry, it seems absolutely unacceptable that the new definitions would generate additional expenses to operate the UCITS already included in the scope of the Directive.

The Commission seems to have come to the conclusion that the implementation and effect of the Directive in the context of UCITS has been satisfactory. The industry is of the opinion that the actual extension also is likely to have a material cost impact on the operation of UCITS, without any proportional benefit.

All this leads us to the conclusion that the rationale behind these measures should be further refined. Unless there is clear evidence that these vehicles create distortions on the European market, it would be preferable to either maintain the status quo or to explicitly exclude income paid by non-public vehicles and vehicles which do not distribute cross border from the definition of interest income.

### HOME COUNTRY RULE AND GRANDFATHERING RULES

When it comes to the home country rules (HCR) two aspects of the operations of the actual Savings Directive would have to be clarified, i.e. the asset testing as well as the income tax calculations, the so-called TIS and TID.

The new version of the Directive includes rules with regard to asset testing. The basic test constitutes the evalua-

tion of the investment policy as defined by the fund rules, which is completely in line with the actual practice. In case the prospectus does not lead to a clear conclusion, the new Directive requires a calculation based on the average exposure of assets at the beginning and the end of the accounting period to characterize the fund. This is not in line with the actual practice as the Luxembourg industry bases its calculation on the annual and semi-annual reports. While this practice gives a more reliable result, it is not appropriate that additional costs for a change in line with the new rules should be borne by the industry. On the other hand in certain circumstances and in light of a potential extension to non UCITS vehicles, it might well be that semi-annual accounts would not be available. Therefore it should be specified that the annual asset test as in the new rules is a minimum requirement and that more frequent testing is allowed.

The rules as proposed for newly established funds should be completely dispensed from the proposal, as an average taking into account the date of incorporation will always lead to an unsatisfactory result: by definition upon incorporation all assets of the funds are in cash.

When it comes to the TIS and TID calculations no home country rules recognition has been envisaged. The reference in article 6(1) last paragraph repeats the option of limiting the amounts in UCITS redemption proceeds to the interest included therein. This was already in the old version of the Directive and seems useless. The EU Member States should in order to facilitate the operation of a common market and to limit the compliance cost establish home country rules for TIS and TID calculations.

It is also important to mention that an extension of the actual rules to new products whether innovative instruments, insurance products or non-UCITS should in all cases be applicable as from the date of entry into force of the new rules versus a fixed date, i.e. December 1, 2008, as given in the actual proposal. For the TIS and TID determination it should also be specified that the calculation is effective from the date of entry into force avoiding indirectly any retroactive application.

## DE MINIMIS RULES

In principle the "de minimis rule" is confirmed by the proposal. It seems however that the application is limited to article 6(1c) (distribution made by UCITS). In the old version the derogation also applied to article 6(1d) (redemption proceeds of UCITS). In its commentaries the Commission has given neither any argumentation leading to the change, nor explained the objective pursued. In the new version it should be made sure that the "de minimis" qualification is final regardless of whether the investor invests directly or indirectly into a "de minimis" fund. As a matter of fact while on one hand it should be excluded that potential advantages could be achieved by investing in a fund of fund structure, on the other hand fund of funds should not be discriminated in comparison to direct investments.

On top such discrimination should have a major cost to the fund industry as for the time being "de minimis" funds do not proceed to TIS/TID calculations. As a consequence these calculations would have to be made by the fund of fund operators which is next to impossible as any detailed information with regard to the underlying "de minimis" fund might not be available or might be very expensive to obtain.

## NON EU UCITS

The Commission has made very clear its intention to extend the scope of application of the Directive to all types of non EU funds. In its commentaries the Commission stated that its intention is to align the Directive to the actual OECD definition when it comes to funds. It seems more than strange that the wording in the proposal seems to be in contradiction with the actual OECD definitions. As a matter of fact the OECD excludes from the fund definition any entities which apply restrictions to a limited group of investors, while the Commission formally includes those vehicles. Further attention should be paid to these definitions and in any event these concepts would be part of the bilateral negotiations prior to the new proposal being adopted.

## NEW RESPONSIBILITIES FOR PAYING AGENTS

The current Directive covers exclusively interest payments made for the immediate benefit of EU beneficial owners. Indeed, payments made through interposed entities for the ultimate benefit of EU beneficial owners are out of scope. In consequence, it was proposed to apply the look-through approach on interest payments made to certain entities or legal arrangements effectively managed outside the EU by identifying the beneficial owners on the basis of the information available under the anti-money laundering provisions (so called look through principle). A major criticism of this approach is that the Commission refers to the term of effectively managed rather than the term of place of incorporation of these entities. The latter is the location a paying agent can establish with certainty on the basis of the usual documentation requirements. It seems to be out of question to impose on any paying agent the burden of establishing the place of effective management of any entity.

It goes without saying that the obligation to apply the Directive to the beneficial owners as defined by the Anti-Money Laundering (AML) rules would potentially create a huge administrative burden on paying agents. Although the information needed for the identification is already available at the level of the paying agents, most of the time it is only available in paper format, while it has to be input in the IT systems to guarantee a proper and efficient application of the Proposal. Therefore, it is to be hoped that paying agents will be given sufficient time in order to update their administrative routines and IT systems, if that goal would be pursued.

It should also be noted that with the enactment of the proposed rules with regard to paying agents, EU resident funds might qualify as paying agents in certain circumstances. This could be the case if for example a fund pays out interest income through an economic operator (e.g. bank) established outside the territorial scope of the Directive, i.e. Singapore, Hong Kong, potentially United States and if it is aware that the payment

is made for the ultimate benefit of a EU beneficial owner (nominative share holder register) living in one of those countries. In such a situation, the EU fund would be considered as paying agent and would consequently have withholding and/or information exchange obligations even though it is not the last intermediary in the chain. Although the rationale behind this measure might seem logical, it would result in additional, and disproportionate, administrative tasks for EU funds. In addition, it would create additional disparity between paying agents established in the EU and those established in third countries.

Other proposed amendments are clearly in contradiction with the Commission's stated objective of limiting additional administrative tasks for paying agents. One such provision explicitly requires paying agents applying withholding tax to report to their home country the number of beneficial owners broken down by their country of residence.

## LIST OF RESIDUAL ENTITIES

The complex anti-avoidance concept "paying agent upon receipt" has been clarified with the adoption of a "positive" definition of intermediate structures (including trusts, transparent entities...) to be charged with obligations to act as a "paying agent upon receipt". In this respect a "positive" list, including entities and arrangements to be considered as "paying agent upon receipt" in each Member State, is introduced in Annex III of the proposed Directive. The new positive definition is based more on substance than form. Hence, the annex refers to the concept of "place of effective management". Bearing in mind that the concept of place of effective management of an entity varies from country to country and that a clear definition has not been included in the proposal, a more pragmatic and less burdensome solution would be to identify the place of incorporation of said entity.

However, UCITS, entities that manage assets of a pension fund or an insurance business, charities and joint accounts are not covered by the term "residual entity". Consequently, this new list of residual entities should not have a major impact on the Luxembourg fund industry.

## TIMING

It is currently proposed that the new Directive be implemented by the Member States on the first day of the third calendar year in which the Directive enters into force. This would mean that Luxembourg would have to implement the revised Directive on 1 January 2012 at the earliest if the proposal is adopted in 2009. It has to be noted that the time line does not take into consideration any necessary negotiation with non EU countries to establish the level playing field the EU industry needs in order to avoid further distortions.

## END OF THE WITHHOLDING TAX PROCEDURE?

In an endeavor to prevent tax evasion, the withholding tax procedure has been

fiercely challenged by some opponents within the EU Commission. Pressure has mounted in recent months following the Liechtenstein tax fraud and the massive injection of public funds into the fragile financial system. Some members of the Commission have pushed for the withholding tax method to be abandoned as early as 2014 (i.e. three years after the entry into force of the 35% withholding tax rate in 2011). Although the proposal does not contain any such provision, additional pressure is to be expected during the negotiation process.

## CONCLUSIONS

Luxembourg is the source of roughly 35% of the total volume of exchanges operated within the EU in 2006. In addition Luxembourg has operated 64% of the withholding tax amount levied by EU Member

States in 2006. Thus, in the light of these statistics, Luxembourg should be self confident in approaching the negotiations and make sure that the new proposal does not entail unacceptable administrative burden for the industry. To achieve this goal balanced and well reasoned changes to the actual proposal are unavoidable. ■

Georges BOCK  
Partner, Banking & Finance  
KPMG Tax Luxembourg