INFORMATION SHEET NO.26

The E.U. Savings Tax Directive

September 2003

Introduction

Cyprus has joined the EU on 1 May 2004. Already in 2000, Cyprus committed itself to the OECD that it would eliminate harmful tax practices by the end of the year 2005 and that it would comply with international standards of transparency, exchange of information and tax competition. As far as the European Union is concerned, Cyprus must conform to the *acquis communautaire* including the EU Code of Conduct and to comply with this commitment, it has undergone a wholesale review of its tax regime, effective as of 1 January 2003.

The commitments to the European Union however are ongoing and Cyprus must be aware of what they are. What are the implications of the Savings Tax Directive?

The E.U. savings Tax Directive

In accordance with the June 2000 Feira European Council conclusions, the European Finance Ministers (ECOFIN) meeting in Brussels on 21 January 2003, committed themselves to adopt the draft Directive on the Taxation of Savings. On 3 June 2003 the ECOFIN meeting in Luxembourg finally agreed on a tax package aimed at combating harmful tax competition. The provisions of this tax package are threefold and include a modified Savings Tax Directive, a Code of Conduct for business taxation and a Directive to eliminate withholding taxes on interest and royalty payments between associated companies of different Member States.

The Savings Directive is due to be implemented into the national laws of participating States from 1 January 2004 and will be applied from 1 July 2005. Its aim is to ensure 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 can be subject to effective taxation in accordance with the national laws of the latter Member State. Adoption of the proposed Directive will signal the end of banking secrecy as we know it – the countries and territories which will subscribe to it will either commit themselves to an automatic information exchange program or will implement a transitional withholding tax at source.

E.U. Member States are already cooperating in exchanging information on cross border interest on savings. Bilateral Tax Treaties include a clause providing for information exchange and there is an EC Directive on Mutual Assistance in Tax Matters (79/799) which provides for information exchange on request, spontaneously and automatically. The problem with the clauses in Tax Treaties and with the Mutual Assistance Directive is that they allow Member States to refuse to provide information in certain instances, e.g. if they would not under their domestic laws or administrative practices be able to carry out or collect this information for their own purposes or if the applying State itself would not be in a position to provide similar information if required.

Moreover, the clauses in tax treaties and the Mutual Assistance Directive do not provide for common rules concerning the details of the information to be provided or the way the information exchange should be carried out with the result that even where information exchange is forthcoming, it is not in a user friendly format.

The Directive on the other hand, will provide complete and comprehensive regulation ensuring automatic information exchange in a detailed and intelligible manner. As for its scope of application, the Directive will be applied on interest income from savings of an individual in one EU member state paid by a paying agent resident in another EU member state.

The Directive will contain provisions ensuring that:

a) 12 Member States will implement automatic exchange of information as of 1 July 2005. However, the provisions of the Directive will only apply from 1 July 2005 provided that from the same date:

- Switzerland, Liechtenstein, San Marino, Monaco and Andorra apply measures equivalent to those contained in the Directive (i.e. either automatic information exchange or withholding) pursuant to agreements entered into by them with the European Community, and
- All relevant dependent territories (Channel Islands, Isle of Man, Caribbean dependent territories) apply either automatic information exchange or withholding tax in relation to interest payments made by paying agents in their territory.

b) New customer documentation rules will take effect on 1 January 2004.

c) Austria, Belgium and Luxembourg will, as of 1 July 2005 implement a transitional withholding tax that will rise in stages to reach 35% in 2010, with 75/25 revenue sharing (75% will be remitted to the Member State of residence and 25% will be retained by the State where the account is held). This transitional period will come to an end at the end of the first full fiscal year following the later of:

- The date on which the last agreement enters into force between the European Community and Switzerland, Liechtenstein, San Marino, Monaco and Andorra which provides for the exchange of information upon request in relation to interest payments to EU beneficial owners made by paying agents in these territories; and
- The date on which ECOFIN unanimously agrees that the US is committed to exchange of information upon request with respect to interest payments made by paying agents in the US.

The implications of this agreement are far reaching. In effect, throughout the EU, dependent territories and Switzerland, there will either be an automatic exchange of information on non-resident bank accounts or a withholding tax to interest arising from such deposits. The withholding tax rate may be punitive (it will rise to 35% in 2010) and will undoubtedly reach greater levels than those which would have been payable had the savings been reported to the taxpayer's country of residence. This is the price of secrecy.

The EU is aware of the risk that if the Member States adopt the Directive, the savings in question may easily flow out of their current EU locations to more tax efficient jurisdictions. Precisely because of the risk that the Directive could incite paying agent operations to relocate outside the EU, the European Council decided that the adoption of the Directive would be preceded by discussions with the United States and key third countries (Switzerland, Andorra, Monaco, Liechtenstein and San Marino) and the dependent and associated territories of the United Kingdom and the Netherlands. If these countries and territories adopt similar measures as it is expected they will, then the EU paying agents will be on level playing field with their main competttors outside the EU.

Companies

Interestingly enough, legal persons have been excluded from the scope of the Directive. There is no requirement for paying agents to report interest paid to non-resident companies, only to non resident individuals. The rationale provided by the European Commission for this omission is that "there are many more problems of tax evasion in the individual taxation area than in the company tax area." The Commission does concede that the omission raises concern that individuals may claim to be representatives of companies in order to avoid the application of the Directive, but in a rather sweeping way dismisses this concern with a "hope" that Member States will "be able to establish the true identity of beneficiaries of interest and that the scope for tax evasion will be limited".

Alternative route

There are a number of reactions of individual investors which may be anticipated. A popular reaction may be to move their bank deposits from individual ownership into corporate ownership. Yet another reaction may be to change the type of investment from a simple bank deposit to an insurance based contract which is excluded from the scope of the Directive.

In fact the Directive is still unclear in a number of areas and 1 July 2005 which is the provisional implementation date may be too ambitious a target.

But there is further scope for evading the provisions of the Directive because it does not apply to certain financial arrangements such as insurance based products and derivative contracts that produce an interest return. Also, although the Directive is aimed at reporting interest paid to individual investors, it also requires reporting interest paid to 'residual entities', such as trusts, which could potentially act as conduits for the payment of interest to individuals. It will be difficult if not impossible in practice to distinguish such conduit entities from legitimate ones.

Cyprus

So how does this affect Cyprus? Since joining the EU in May 2004 customer documentation rules apply. By 1 July 2005 if the Directive is adopted by the EU, Cyprus will apply an automatic exchange of information system.

In the near future, a Cyprus resident will have the details of any foreign account held notified to the Cyprus tax authority. This was immaterial until recently because Cyprus did not levy any tax on interest held in foreign bank accounts. As of 1 January 2003 however, interest arising from deposits will be subject in Cyprus to the newly introduced Special Contribution for the Defence Tax, currently set at 10%.

Exemption forms are available for submission in respect of interest earned by non-Cyprus residents with deposits in Cyprus banks as from 1 January 2003. Companies are for the time being excluded from the net of the Directive so a Cyprus company with cash deposits abroad will not be subject to the automatic exchange of information procedure, although in principle this interest should still be declared for Special Contribution taxation if the company is resident in Cyprus.

Conclusion

The global trend for exchange of information is making it all the more difficult to evade tax by holding assets offshore. There are still however legitimate ways for reducing one's tax liabilities.

NOTES:

The above is intended to provide a brief guide only. It is essential that appropriate professional advice is obtained. Our company will be glad to assist you in this respect. Please do not hesitate to contact us.