EU Savings Directive : background history

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In May 1998 the European Commission published a proposal for new legislation to ensure individuals within the EU paid the tax due on 'cross border' interest payments (interest paid on savings deposited in one Member State to individuals resident in another).[1] As initially drafted, Member States would have had to choose either to withhold tax at 20% on these payments or to provide the recipient's State with enough information about them to ensure that they could be taxed on receipt. Concerns about the possible impact on European financial markets led to a revised draft – based on the exchange on information between States – being approved in July 2001.[2] It was also agreed that this measure would only be formally adopted if sufficient reassurances were received from key third countries and relevant dependant territories of Member States that they too would adopt the same or similar measures.

In January 2003 European Finance Ministers reached political agreement that 12 states would implement arrangements for the automatic exchange of information, while Austria, Belgium and Luxembourg would operate a transitional withholding tax. These three states would move to automatic exchange of information if and when suitable agreements were made with other territories.[3] Initially it was anticipated that the Directive would apply from 1 January 2005, though difficulties on reaching agreements with, amongst others, the Swiss authorities, resulted in a six month delay.[4]

This note discusses the background to the adoption of the Savings Directive. Guidance for financial institutions and taxpayers is collated on HM Revenue & Customs site.[5] Since its introduction there have been concerns that the Directive has been far less successful at preventing tax evasion as first hoped, and for several years the Commission and Member States have been engaged in negotiations to amend this legislation.[6] A second Library note looks at these recent developments.[7]

1 EC draft 8781/98, 20 May 1998
2 COM(2001) 400 final, 18 July 2001
3 HC Deb 27 January 2003 cc 607-8W
4 Council Directive 2003/48/EC of 3 June 2003, as amended by Council Directive 2004/66/EC of 26 April 2004 and Council Decision 2004/587/EC of 19 July 2004.
5 http://www.hmrc.gov.uk/esd-guidance/index.htm. See also, HMRC, *Full Regulatory Impact Assessment : implementation of the European Union Savings Directive*, December 2003
6 Details of this work are given on the Commission's site.
7 *EU Savings Directive : recent developments*, SN3273, 16 October 2012

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1 Proposals for a withholding tax on savings (1997-98)

During the late 1990s the practice of 'unfair tax competition' between Member States became a controversial issue, spurring several important initiatives in tax at an EU level. As Colin Mowl, an official at HM Treasury, explained at the time, in evidence to the Lords Select European Communities Committee, "tax competition is where countries use low taxes to attract internationally mobile capital and business. There is no completely precise definition of 'harmful' or 'unfair' tax competition [but] … the international community has come to some consensus that … preferential or discriminatory tax measures are potentially harmful", as opposed to measures that are available to all the taxpayers in a particular jurisdiction.[8]

One area where many countries had particular concerns about tax competition was in relation to national withholding taxes on savings income. This type of tax is deducted by the relevant financial institution at source, paying the money onto the revenue authorities before passing the income on to the individual. However, many Member States did not levy this tax on savings held by non-residents. Revenue authorities were often blocked in their attempts to discover if taxpayers were holding undeclared money in other countries by rules on bank confidentiality.

This was a particular problem for the German authorities, as significant numbers of German residents had savings invested in banks in Luxembourg or Switzerland, though the problem was definitely not confined to one country; as Mr Mowl commented to the Lords Select Committee, in the evidence session cited above, "we do not know whether we are losing significant amounts of tax that should be collected from United Kingdom residents. It is quite possible that our residents are evading tax in this way by investing elsewhere."[9]

In November 1997 the European Commission published a series of proposals to deal with this problem: legislation to harmonise tax rules in two areas (cross-border payments of interest on savings, and, cross-border payment of interest and royalties between associated companies), and a political agreement between Member States to refrain from any business taxation provisions harmful to the Community interest (a 'Code of Conduct for Business Taxation').[10] The following month European Finance Ministers agreed that the Commission should prepare

8 *Taxes in the EU: can co-ordination and competition co-exist?*, 20 July 1999 HL 92 1998-99 para 57
9 HL 92 1998-99 p39
10 COM(97) 564 Final, 5 November 1997

detailed plans on the first of these initiatives – legislation to harmonise the taxation of savings income;[11] Ministers agreed a number of principles on which this legislation should be based:

> ***ANNEX 2 :*** **TAXATION OF SAVINGS**
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> To ensure a minimum of effective taxation of savings income within the Community and to prevent undesirable distortion of competition, the Council calls upon the Commission to present a proposal for a Directive on the taxation of savings. The Council considers that the following points might form a basis for that proposal:
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> I. The scope of such a Directive could be limited to interest paid in one Member State to individuals who are resident in another Member State.
>
> II. As a first step towards effective taxation of savings income throughout the Community, such a Directive could be based on the 'coexistence model', under which each Member State would either operate a withholding tax or provide information on savings income to other Member States. A Member State might combine the two. The Directive could contain a review clause, for the purpose of determining to what extent further progress would be conceivable with a view to better effective taxation of savings income.
>
> III. Any withholding tax on interest payments made to residents of other Member States could, in principle, be levied by the paying agent. Refinement of this method might be needed in order to counter tax avoidance and evasion more effectively and to avoid double taxation. The arrangements for checking the residence for tax purposes of beneficiaries should not be too cumbersome.
>
> IV. The provisions of such a Directive should take into account the need to preserve the competitiveness of European financial markets on a global scale.
>
> V. Furthermore, it would be advisable for the points set out above to be adopted as widely as possible. To this end, Member States should undertake to promote the establishment of equivalent measures in third countries, at the same time as discussions on the Directive are taking place; they should also commit themselves to promoting their adoption in territories to which the Treaty does not apply. In particular, Member States with dependent or associated territories or which have special responsibilities or taxation prerogatives in respect of other territories should commit themselves, within the framework of their constitutional arrangements, to ensuring that equivalent measures are applied in those territories.[12]

At this stage, several Member States raised specific concerns about this initiative; in the UK's case, the Government took the view that the directive "should not apply to Eurobonds and similar instruments."[13] Eurobonds are traditionally defined as bonds sold outside the county of incorporation of the issuer. They characteristically pay interest without tax being withheld. Issuers include sovereign entities, international organisations, industrial, banking and commercial companies. The principal market for these financial products is in London.

The Commission published this draft legislation in May 1998. (The text was a revised version of draft legislation published in 1989 - EC draft Directive 4763/89 - on which negotiation had

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[11] Statement on ECOFIN meeting on 1 December 1997 [HC Deb 9 December 1997 cc 513-514W]
[12] *Official Journal* C 2, 6 January 1998, at 1
[13] *ibid.*

stalled for lack of consensus.[14]) The purpose of this measure and a summary of its provisions, was provided in the document's explanatory memorandum; an extract is given below:

> The European financial area, the creation of which was made possible by the liberalisation of capital movements, cannot deliver all its benefits if savers' decisions are determined by the possibility of avoiding tax instead of being taken in the light of a comparison between investment alternatives based on their intrinsic merits. The need for joint action to eliminate these economic distortions is rendered all the more urgent by the start of the third stage of economic and monetary union, which will further facilitate the cross-border investment of savings.
>
> The budgetary discipline required of Member States also means that the erosion of tax bases linked to the absence of guarantees concerning a minimum of effective taxation on the cross-border investment of savings is becoming less and less acceptable. Against this background, the absence of guarantees concerning a minimum of effective taxation on the cross-border investment of savings is also hindering Member States' efforts to restore the balance in terms of the burden of taxation between the different factors of production and thereby to achieve a reduction in the level of total taxation on income from employment, something which would be certain to have a favourable impact on job creation and the fight against unemployment …[15]
>
> Having regard to the principles of subsidiarity and proportionality … the proposal is based on the "coexistence model", under which each Member State applies a withholding tax at source or provides information on income from savings to other Member States. The advantage of the coexistence model is that Member States which are prepared to apply one of these systems can encounter difficulties in applying the other one and this makes the adoption of a common system for the whole of the Community very difficult …
>
> The Commission has come to the conclusion that a balanced solution to the problem of setting the rate of withholding tax would be to adopt a minimum rate of 20%, together with a corrective mechanism enabling the beneficiary, at his own initiative and without encroaching on the confidentiality of banking information, to be taxed according to the rules of his Member State of residence. This corrective mechanism is based on the issue, by the tax authorities of the Member State of residence, of a certificate proving that the beneficiary has informed those authorities of the amount of interest to be received.
>
> Each Member State may choose one, but only one, of the two systems and apply that system to all payments of interest in its territory to residents of all other Member States. Moreover, it is possible for the beneficial owner receiving a payment in a Member State which has chosen the withholding tax system, to obtain a modification of this system by the certificate process; the beneficiary can ensure that he is taxed exclusively in the Member State where he is resident for tax purposes as if he were receiving a payment in a Member State which had opted for the information system.[16]

In their report on taxation in the EU, published in July 1999 the Lords Select Committee set out how the information system and withholding system were intended to work in practice:

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14 HC Deb 19 May 1999 cc 365-366W. The proposal was the subject of a debate on the floor of the House (HC Deb 15 May 1989 cc 124-140), and an earlier report by the Lords Select European Communities Committee (*Withholding tax*, 13 June 1989 HL 55 1998-99).

15 [Mario Monti, then European Commissioner for Internal Market and Taxation, set out this argument in a speech on 27 November 1998 to the Kangaroo Group Conference in London (Speech/98/272).]

16 EC Draft 8781/98, 20 May 1998

The two systems are intended to result in the same final tax burden on any given transaction. The draft Directive requires that Member States treat withholding tax paid on interest received from abroad as an advance payment of the taxpayer's national income tax. If the amount of income tax due on the payment would be less than the withholding tax already deducted, the implication would be that the taxpayer should be refunded the excess. There are also provisions to allow taxpayers to obtain a certificate from their domestic tax authorities which would allow them to ask for interest to be paid in another Member State without the withholding tax being charged, so that individual taxpayers could in effect opt to be subject to the information system instead of the withholding system. Like the requirement that full credit should be given for the withholding tax, this provision appears to be intended to ensure that taxpayers do not pay more in withholding tax than their final tax liability.

From the point of view of the taxpayer, there is a cash flow difference between the withholding and reporting options, because tax would be paid earlier under the withholding tax option. And if taxpayers receiving income subject to the withholding tax chose not to report it to the tax authority in their country of residence, they would gain if the uniform rate was lower than that in their country of residence (where they would be taxed under the reporting option).[17]

2 Critiques of an EU-wide withholding tax (1998-99)

2.1 The City of London

Many in the UK financial industry strongly criticised the Commission’s draft legislation, on two grounds: first, that it would not prevent tax evasion because taxpayers would choose to hold money outside the EU; and second, it would undermine the industry, as banks and brokers relocated to other financial centres, such as Zurich, to avoid the tax.[18] Some argued that one of the main reasons for the growth in the international bond market in London had been the imposition of a withholding tax on non-resident investors by the USA, resulting in a major shift in investment activity away from the States.[19]

In October 1998 the City of London published a short report on the impact of regulatory actions - including withholding taxes - on financial markets.[20] Its author - Professor Richard Dale - argued that "financial regulatory initiatives implemented in one national jurisdiction may cause financial activity to shift to other, more permissive, jurisdictions. This reflects the global mobility of capital flows and the fact that the re-routing of financial business through alternative financial centres is almost costless."[21]

Professor Dale pointed out that the German government's decision in late 1987 to impose a 10% withholding tax on domestic interest income from January 1989, led to “a massive shift out of German domestic bonds by foreign investors in 1988 (net purchases by DM 23bn were followed by net sales of DM 9bn in 1988), a surge in the acquisition of foreign currency bonds by German investors and a simultaneous shift of funds from Germany to Luxembourg.” In turn the German authorities abolished the tax in July that year. The Deutsche Bundesbank Annual Report for 1998 noted, “in comparison with major financial centres abroad, domestic securities

[17] HL 92 1998-99 p 37

[18] For example, “Euro could spark tax dilemma”, *Financial Times*, 2 June 1998; “Chancellor threatens to block EU tax plans”, *Financial Times*, 6/7 June 1998; “EU withholding tax would be a useless piece of bureaucracy”, *Financial Times*, 8 June 1998

[19] For example, “Leader: EU taxation”, *Financial Times*, 24 March 1999

[20] “The City hits back on EU tax directive”, *Financial Times*, 3 November 1998

[21] Corporation of London, *Consequences of regulatory impositions on financial markets*, October 1988 p 1

markets … display weaknesses in their tax, organisational and legal/institutional structure which put them at a disadvantage when competing with major foreign financial centres. The announcement and introduction of the withholding tax on domestic interest income … constitute a striking example of this."[22]

One of the arguments made by the Commission for the new tax was that it would allow Member States to reduce taxes on labour, boosting employment. The Bank of England argued that this was unlikely, in evidence to the Lords European Communities Committee:

> Because capital is mobile, an increase in the rate of tax on capital income is likely to lead to a reduction in the size of the tax base either through capital flight or by increasing the cost of capital to firms, thereby reducing investment and, over time, the capital stock. Both may limit the scope for governments to lower taxes on labour. There is some evidence to suggest that the overall level of taxation–not simply the level of taxes on labour income–is a key influence on employment. On this basis, a switch between taxes relevant to the production chain is unlikely to have a material effect on employment–the burden of taxes on employers will be shifted on to employees through an adjustment in contractual wages.
>
> A reduction in labour taxes paid for by an increase in taxation of capital may have a favourable short-term effect on employment because it may increase labour supply without at first reducing labour demand. But in the long run, the demand for labour will fall, which is likely to offset the short-run effect. In sum, the proposition that lowering tax rates on labour income, facilitated by an increase in rates on capital income, will reduce unemployment is unproven, and policy recommendations derived from it should therefore be treated with caution.[23]

In their evidence to the Committee, the British Banker's Association raised another concern: that the tax would encourage borrowers to 'call' their bonds – that is, redeem them before their due date – at a considerable cost to investors:

> The terms of issue of bonds typically require an issuer to compensate an investor for any new tax levied by the country of the issuer. Compensation takes the form of grossing up the net payment.
>
> Individual investors hold between 10 per cent and 20 per cent of issued Eurobonds and only a proportion of this is held by EU residents. The Commission argues that the cost of the gross-up to the issuer would therefore not be great. However, in a significant minority of cases an issuer faced with making gross-up payments is entitled to redeem the whole amount of the issue, not just the proportion held by individuals. Such redemption would be at par value. Because of the recent decline in interest rates par value is usually well below current market value. Issuers therefore have a significant economic incentive to take advantage of the opportunity to call existing issues and refinance at lower interest rates. By contrast, investors, including institutions such as pension funds, stand to incur substantial capital losses.
>
> A study carried out by IPMA and LIBA[24] in 1998 concluded that if seven per cent of outstanding bonds were called, as sampling suggested was a reasonable expectation, a transfer of $5 billion from investors to issuers was possible …The resulting uncertainty is likely to provide a big incentive for companies to issue bonds in non-EU locations … Because the typical gross-up and call clauses in Eurobond agreements provide that an

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[22] *op.cit.* p8

[23] *Taxes in the EU: Minutes of evidence*, 20 July 1999 HL 92 1998-99 p 29

[24] The International Primary Market Association & the London Investment Banking Association

issuer is only obliged to gross up for a tax imposed by its own jurisdiction, only EU issuers will be affected. This, together with the desire of investors to continue receiving gross interest, is likely to raise the cost of funds to EU borrowers. A 1994 study by Dr Andrew Sentance, then of the London Business School, suggested that a similar withholding tax could add 0.3 per cent to the average interest cost of debt finance. If EU borrowers were to raise funds in the US they would also experience higher costs.[25]

2.2 The Lords European Communities Committee

One final concern was that the 'co-existence model' proposed by the Commission – giving States the option of adopting either the information system *or* the withholding tax system – was impractical; in their final report the Lords European Communities Committee took this view:

> [Under the co-existence model one would see] some Member States applying a withholding tax and others choosing to report income of non-residents to their country of residence … The revenue from a withholding tax would accrue to the Member State where the interest payment was made, whereas under the reporting option the country of residence would receive the revenue from whatever tax it chose to impose. Member States choosing the withholding tax option would thus gain tax revenues at the expense of those choosing the cross-frontier reporting option, unless withholding tax receipts were passed on to the country of residence of the interest recipient.
>
> The Paymaster General told us that Denmark, the Netherlands and Sweden had put forward the proposal that there should be such revenue sharing, but that there had been no discussion of how it would work. It would presumably be possible only if information were collected from banks about the country of residence of investors - and the banking secrecy arrangements which may have led countries to opt for the withholding tax in the first place might also prevent the collection of information about residence …
>
> We have serious doubts that a co-existence model (with some Member States adopting the withholding tax option and others the reporting option) could work in the form currently proposed. The problem of distributing the resulting tax revenue is a major one, which the Commission's proposal does not address. We are puzzled by this, and we wonder whether it results from a wish to press all Member States into adopting the withholding tax rather than the alternative route; if so, we would regard it as disingenuous. We agree with the Government that, if any change is to be made, the adoption of the reporting option on an EU-wide basis would be preferable to the imposition of a withholding tax.[26]

The Committee acknowledged the force of the other arguments raised against the withholding tax, but took the view that there was insufficient evidence to predict the potential impact on this measure on the City, and so, were undecided as to the best course forward:

> Despite claims and counter-claims, we are left with no firm evidence about the likely scale of the effect of a withholding tax on the City of London. There is a genuine fear, reasonably based, that its introduction would damage the City by making Eurobonds issued from a tax haven relatively more attractive to EU investors. We accept that there would be damage as a result of an outflow of business. We tried to collect evidence which would enable us to quantify the likely extent of this damage, but such figures as were forthcoming were insufficiently substantiated and too disparate to be convincing …
>
> It is argued in some quarters that there are no feasible amendments to the proposal which might make it acceptable, and that unless the proposal is withdrawn the United Kingdom

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[25] *Taxes in the EU: Minutes of evidence*, 20 July 1999 HL 92 1998-99 p 9
[26] HL 92 1998-99 pp 42-43

> should use its veto, even though this could mean paying a price in negotiating terms. Another view is that it may be possible to find an acceptable version of the proposal, either by making appropriate exemptions from the withholding tax (to limit damage to the Eurobond market, and hence to the City of London), or by ensuring that Member States choosing the reporting option do not thereby lose revenue. Without access to the evidence about the likely scale of impact on the City which the Government has been collecting for the past year, we have no basis on which to reach a conclusion on this proposal.[27]

2.3 The UK Government

In September 1999 the Government presented its formal response to the Commission's proposals at a meeting of European Finance Ministers, arguing "thorough exchange of information on as wide an international basis as possible" was the best way to tackle tax evasion, but that this was being blocked by "continued insistence on out-dated arguments for banking secrecy in some member States and in (important) third countries."[28] Some details of the provisions for bank secrecy in other States were given in the Lords European Communities Committee report:

> We asked the Government for a summary of the position on banking secrecy in other Member States … The Note [provided] gives details of the situation in each Member State, with the *caveat* that "legislative and administrative arrangements in other countries are a complex area on which the United Kingdom cannot speak with full authority" … It says that in some Member States the tax authorities can obtain no access. In Austria, banking secrecy has recently been made a provision of the constitution; in Germany, the tax law respects the relationship of strict confidentiality between the bank and its customer, and under the Fiscal Code tax authorities cannot request information on bank accounts to verify the correct reporting of interest … in Luxembourg there is explicit legislative provision for banking secrecy.
>
> In other Member States, tax authorities can get access when they have reason to believe that a fraud might have occurred; this is the case in Belgium, Spain and Portugal. In a third group, there is legislation requiring banks to give access to the tax authorities; this applies in Finland, France, Ireland, the Netherlands and Sweden, as well as the United Kingdom.[29]

In evidence to the Committee, the then Paymaster General, Dawn Primarolo, had noted that international discussions of bank secrecy rules were continuing, but refused to say when real progress might be made, as "there are so many different players in this discussion."[30] More positively, the Minister state that the German government had changed its view on bank secrecy, and now took the view that exchange of information promised the best way forward.[31]

The Government's report on the potential impact of the withholding tax argued that the proposal had potentially damaging effects on the international bond market from three sources: financial market uncertainty; loss of competitiveness; and, reduced financial market innovation – though it did not quantify the likely extent of the damage. It put forward two possible amendments to

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[27] HL 92 1998-99 pp 12-13

[28] HM Treasury, *International bonds and the draft directive on taxation of savings: a paper by the United Kingdom*, September 1999 para 12. See also, "Tactics to the fore in Brown's tax proposals", *Financial Times*, 13 September 1999.

[29] HL 92 1998-99 pp 42-43

[30] *Taxes in the EU: Minutes of evidence*, 20 July 1999 HL 92 1998-99 p160 Q419

[31] HL 92 1998-99 p 12

the draft directive: either a specific exemption should be created for interest received from Eurobonds, or the terms of the directive should be amended, so that it only covered interest for certain specified deposit taking business.[32]

3 Agreement on information exchange (1999-2000)

In December 1999, the then Finnish Presidency and the European Commission published a compromise proposal, based on two principles: to provide protection for existing bond issues, and, to allow the Directive to be applied to new issues using customer identification procedures already in place under existing domestic rules.[33] The reaction to this proposal from the City was sceptical - the *Financial Times* quoted the head of global capital markets at JP Morgan, Joseph Cook, as saying, "Brussels is seeking to apply a band aid to what is a thoroughly bad law. The compromise imposes less of a cost on the City than before but it is still a fundamentally bad piece of legislation"[34] – and in the event the UK refused to endorse it.[35]

At a meeting of the European Council later that month, Member States agreed that the issue needed 'further study' and postponed any decision for six months.[36] In a statement to the House the then Prime Minister, Tony Blair, described this as a "sensible way forward", adding that the UK would "continue to work for a solution to the issue of tax evasion that rightly concerns some of our EU partners, Germany in particular. But this cannot be done at the expense of a major European financial market based here in London."[37]

In February 2000 the Government published a second submission on the draft Directive, setting out a number of arguments for basing legislation on the exchange of information:

> Exchange of information to ensure effective taxation of cross-border interest offers a number of advantages over a "co-existence" approach …
>
> First, exchange of information allows for the right amount of tax due on the income from savings to be collected. For those countries which tax the savings income of their residents at the marginal rates which apply to income in general, a withholding tax is unlikely to be the marginal rate at which the investor should be paying tax in his state of residence.
>
> Second, exchange of information allows savings income to be taxed in the right country - that is, the investor's state of residence rather than solely in the state of source for the investor's savings income. The "co-existence approach" does not allow for this and this is why several Member States have argued for revenue sharing.
>
> Third, exchange of information encourages compliance with the tax system. It provides a deterrent to the non-declaration or under-declaration of income. In contrast a withholding system, without exchange of information, might appear to give the impression of legitimising tax evasion since it fails to deter non-declaration.

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[32] *International bonds and the draft directive on taxation of savings*, September 1999 pp 20-23

[33] "Britain offered way out of EU tax dispute", *Financial Times*, 9 December 1999. Details of the proposal were given in a short document published by the Presidency (Council of the European Union, *Letter from EU Ministers of Finance: taxation of savings*, 7 December 1999)

[34] "Bankers welcome withholding tax deal", 9 December 1999

[35] According to the *Financial Times*, "British officials insisted the UK had not wholly rejected the paper. But London felt there was insufficient detail for the compromise proposal to be the basis of an agreement" ("Britain still at odds with European Union partners", 10 December 1999).

[36] European Council press notice, 11 December 1999

[37] HC Deb 13 December 1999 c 23

> Acceptance by the EU of the "co-existence" model in Community legislation might be interpreted by taxpayers as a signal that non-declaration to the taxpayer's state of residence will be tolerated.
>
> Fourth, exchange of information helps wider compliance with the tax systems of Member States, including tackling the serious problem of cross-border "laundering" of the proceeds of tax evasion. Exchange of information will often draw the attention of the country of residence to the existence of an asset which may have been funded from income, profits or gains which have themselves been hidden from the tax authorities. In turn, these activities could now be taxed. Withholding conveys none of these advantages.
>
> Fifth, exchange of information is easy and efficient. It would be sufficient to draw the attention of the country of residence to the existence of the income-producing asset - the tax authorities could then seek sufficient information from the investor to work out the tax liability. In contrast, applying withholding might in some circumstances require a financial institution to perform complex calculations not needed for its own purposes. In addition, a withholding system would require additional administrative costs in order to manage tax deductions or investor certification.
>
> Sixth, exchange of information is good for the honest investor, since it does not lead to the cash flow disadvantages associated with a cross-border withholding tax system. Seventh, exchange of information produces equity between Member States. It precludes the likelihood of capital flight from countries providing information to countries opting for withholding under "co-existence" arrangements. Dishonest investors determined to evade tax will generally prefer to suffer a (minimum) withholding tax rather than have information passed to their country of residence, and will choose where to invest their savings accordingly. This would lead to undesirable distortion of competition, by putting financial institutions in withholding countries at a tax-driven competitive advantage.
>
> Exchange of information for tax purposes is consistent with the trend to greater international co-operation and transparency in international financial systems, encouraged by international initiatives in both tax and non-tax fields. Even if withholding arrangements were adopted by all countries globally, this would not provide an effective solution to evasion of tax on savings income. They would not allow Member States to collect the full amount of tax due on their residents' savings income, nor to deter and detect the "laundering" of the proceeds of tax evasion through investment abroad.[38]

The report did not produce any consensus,[39] and the next month in his Budget speech the then Chancellor, Gordon Brown, took unilateral action, announcing the abolition of the UK's own withholding tax on international bond interest from April 2001, as well as legislation "so that we can proceed on the basis of exchange of information nationally and internationally."[40] Details were given in a press notice at the time:

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[38] HM Treasury & Inland Revenue, *Exchange of information and the draft directive on taxation of savings: a paper by the United Kingdom*, February 2000 paras 3.1-9

[39] The *Financial Times* quoted Frits Bokestein, then Commissioner for Internal Market & Taxation, as saying, "at least two and possibly more Member States are not prepared to accept [exchange of information] … I am afraid the argument won't fly" ("Brussels attacks alternative for withholding tax", 1 March 2000). See also, "EU deadlock on withholding tax set to continue", *Financial Times*, 30 May 2000

[40] HC Deb 21 March 2000 c 861

> The package includes legislation which will help promote and protect the competitiveness of UK and EU financial markets by:
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> - Abolishing current tax rules for financial institutions which act as Paying and Collecting Agents of international bonds and foreign dividends from April 2001. 40 pages of complex legislation will be swept away.
>
> and allow the Inland Revenue[41] to:
>
> - Obtain routine information about the UK savings income of all individuals. To ensure a level playing field, this information will not be exchanged with other countries, other than on a reciprocal basis The Government is seeking to establish exchange of information on as wide an international basis as possible to ensure a level international playing field for individuals and businesses
> - Obtain taxpayer information at the request of the tax authorities of another country with which the UK has a double taxation agreement. The law at present gives the Inland Revenue powers to obtain information only if needed for its own purposes or at the request of another EU Member State.
> - Enter into new Tax Information Exchange Agreements with other countries.[42]

In April a breakthrough appears to have been made at a meeting of the Finance Ministers of France, Germany, Luxembourg, Portugal and the UK, and at the European Council meeting on 20 June, Member States agreed a deal based on the principle of information exchange.[43] In a statement to the House the next day, the Prime Minister, Tony Blair, called it "an excellent agreement for Britain and for Europe":

> The most contentious issue at the Council itself was the question of how best to tackle the problem of cross-border tax evasion within the European Union. For many years, the Commission, and indeed most member states, have argued that the best way to deal with that issue is through tax harmonisation--by requiring all countries to introduce a withholding tax on savings income paid out to non-residents. For our part, we have argued consistently that an EU-wide withholding tax would not only be seriously damaging for the City of London, but would be completely ineffective in tackling tax evasion. However, we have also made it clear through the long and complex negotiations that we fully agree with the objective of fighting international tax abuse caused by banking secrecy.
>
> The outcome [of the summit] … was fully in line with the principles and objectives we set out. …. This is a comprehensive agreement, which fully protects the competitiveness of the City. All 15 countries have now agreed to accept exchange of information, not a withholding tax, as the way forward for the EU, and implementation of the European Union regime will depend on the progress made in agreeing similar measures with third countries and dependent territories. Even in the transitional period, only two of the 15 countries have said that they will definitely retain a withholding tax.[44]

One important element of this agreement related to concerns that taxpayers would continue to evade tax simply by relocating their savings to jurisdictions outside the EU. Member States

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[41] [The Inland Revenue was merged with HM Customs & Excise in 2005, to create a single revenue authority, HM Revenue & Customs.]

[42] Inland Revenue Budget press notice REVBN2J, 21 March 2000. Provisions to allow for information exchange are included in the *Finance Act 2000* (ss 145-147) and were debated at the Committee stage of the Bill on 27 June 2000 (Standing Committee H cc 958-979).

[43] "How Lisbon's elite breakfast club broke the deadlock on tax", *Financial Times*, 21 June 2000

[44] HC Deb 21 June 2000 c 339. The agreement was published at this time: *Report from the ECOFIN Council to the European Council on the tax package*, 9034/00, 20 June 2000

agreed any legislation would have to be accompanied by similar provisions applying to dependent or associated territories – namely, the Channel Islands, the Isle of Man, and a variety of territories in the Caribbean. In addition, equivalent measures would have to have been agreed with third European countries, who would be likely beneficiaries of this type of capital flight: namely, Switzerland, Liechtenstein, Monaco, Andorra, and San Marino – as well as the United States of America.

In their report on the deal the European Scrutiny Committee stated, "the Government can properly feel satisfied with the progress it has made in this important and controversial area of Community business", but went on to note, "much remains to be achieved before any Directive can be adopted and the prospect for substantive agreement on the content of the Directive by the end of 2000 may be ambitious."[45] In November European Finance Ministers agreed the 'substantial content' of the directive,[46] and a timetable for further negotiation and final agreement was set in July 2001.[47] Ministers anticipated that the final text would be completed by December 2002, subject to suitable agreements being concluded with dependent and associated territories, and with relevant third countries, though *European Report* commented that this timetable had been "deemed highly optimistic by diplomatic sources."[48]

4 Implementation of the Savings Directive (2001-2005)

In January 2003 European Finance Ministers reached political agreement that 12 states would implement arrangements for the automatic exchange of information, while Austria, Belgium and Luxembourg would operate a transitional withholding tax. These three states would move to automatic exchange of information if and when suitable agreements for information exchange were made with Switzerland, the United States of America, Liechtenstein, Andorra, San Marino and Monaco.[49]

In June 2003 Member States agreed the final form of the directive - Council Directive 2003/48/EC - with a view to it being implemented in national law by 1 January 2004, and coming into effect from 1 January 2005; a summary of its provisions was given in a press notice at this time:

> Under the Directive, each Member State will ultimately be expected to provide information to other Member States on interest paid from that Member State to individual savers resident in those other Member States. But for a transitional period, Belgium, Luxembourg and Austria will be allowed to apply a withholding tax instead of providing information, at a rate of 15% for the first three years (2005-2007), 20% for the subsequent three years (2008-2010) and 35% from 2011 onwards.
>
> These three Member States will implement automatic exchange of information:
>
> - if and when the EC enters into an agreement by unanimity in the Council with Switzerland, Liechtenstein, San Marino, Monaco and Andorra to exchange of information upon request as defined in the OECD Agreement on Exchange of Information on Tax Matters (as developed by the OECD global forum working group on effective exchange of information in 2002) in relation to interest payments, and to continue to apply simultaneously the withholding tax and

[45] European Scrutiny Committee, *Twenty fifth report*, HC 23-xxv 1 August 2000 1999-2000 paras 10.1-10.10
[46] HC Deb 30 November 2000 c 936W
[47] HC Deb 19 July 2001 cc 383-4W; ECOFIN press notice, *2365th Council meeting*, 10 July 2001
[48] "Timetable adopted to conclude the fiscal package", *European Report*, July 14 2001 p II.2
[49] HC Deb 27 January 2003 cc 607-8W; European Commission MEMO/03/13, 22 January 2003

- if and when the Council agrees by unanimity that the United States is committed to exchange of information upon request as defined in the 2002 OECD Agreement in relation to interest payments.

> The Directive has a broad scope, covering interest from debt-claims of every kind, including cash deposits and corporate and government bonds and other similar negotiable debt securities. The definition of interest extends to cases of accrued and capitalised interest. This includes, for example, interest that is calculated to have accrued by the date of the sale or redemption of a bond of a type where normally interest is only paid on maturity together with the principal (a so-called "zero-coupon bond"). The definition also includes interest income obtained as a result of indirect investment via collective investment undertakings (i.e. investment funds managed by a specialist fund manager who places the investments made by individuals in a diverse range of assets according to defined risk criteria).[50]

At this time negotiations were continuing with countries outside the EU for arrangements to accompany the Directive, though a draft agreement with Switzerland had been reached:

> The four elements of the draft of the agreement that has been reached with Switzerland are as follows:
>
> **Withholding Tax**: Switzerland already applies a 35% withholding tax on Swiss source income. Under the agreement, it will commit to withhold a retention tax also on non-Swiss source income at the same rates as Belgium, Luxembourg and Austria under the Savings Directive - 15% during the first three years, 20% for the subsequent three years and 35% thereafter. The scope of the agreement includes, inter alia, the definition of the paying agent, definition of interest, including interest paid on fiduciary deposits and by Swiss investment funds. Switzerland will share the revenue of the tax withheld on non-Swiss source income, transferring 75 per cent of the revenue to the tax authorities of the resident's Member State.
>
> **Voluntary disclosure of information**. The retention tax on non-Swiss source income will not be applied if the taxpayer authorises the Swiss bank to disclose information on the interest payment to the tax authorities. In such cases, that interest income should be subject to taxation in the Member State of residence at the same rates as those applied to interest earned domestically.
>
> **Review clause** stating that the Contracting Parties shall consult with each other at least every three years or at the request of either Contracting Party with a view to examining and if deemed necessary by the Contracting Parties improving the technical functioning of the Agreement, and assessing international developments. On the basis of this assessment, consultation can also take place in order to examine whether changes to the Agreement are necessary to take account of international developments.
>
> **Exchange of information upon request** - for income covered by the draft Agreement, Switzerland will grant exchange of information on request for all criminal or civil cases of fraud or similar misbehaviour on the part of taxpayers. This part of the Agreement may be implemented through bilateral agreements between Member States and Switzerland.[51]

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[50] European Commission press notice IP/03/787, 3 June 2003

[51] *ibid.*

However, negotiations proved more protracted than first hoped,[52] particularly with the Swiss authorities,[53] and in July 2004 Member States agreed to defer the implementation of the Directive six months, until 1 July 2005.[54] Final agreement with the Swiss was achieved in October 2004, with similar agreements being concluded with other European territories over the next two months.[55]

During this time the UK Government introduced legislation to implement the Directive in UK law: principally the *Reporting of Savings Income Information Regulations* (SI 2003/3297).[56] Provision was also made in the *Finance Act 2004* (ss107-115) to ensure that UK residents with savings in one of the States imposing a withholding tax would not be subject to double taxation on this part of their income. When these provisions were debated in Committee, Andrew Tyrie, speaking for the Opposition, was supportive of the Government's approach "because, quite rightly, we do not want to go down the withholding tax route", adding that it was "important to ensure that legislation cannot act as a first building block towards the spread of a withholding tax beyond [Austria, Belgium and Luxembourg.]" In response the then Paymaster General, Dawn Primarolo, responded as follows:

> As [the hon. Member] knows through debates on double taxation treaties, the Government's view, and I think the Opposition's view as well, is that exchange of information is the fairest, simplest and best way to ensure that the right of amount of tax is paid by the right person in the right place. All the arrangements ensure that UK citizens pay tax to the UK, or that German citizens pay it, if liable, to Germany ...
>
> I think that we need to be vigilant on the point that the hon. Member for Chichester made, which is that we need to ensure that we move forward on exchange of information and that there is no sliding back, or any other way in which withholding tax could appear on the horizon. I give him and the Committee a categorical assurance that the Government intend to do precisely that, for all the reasons that we know about: the damage that a withholding tax would do to the City of London, to the financial service industries based in the UK and, in particular, to the eurobond market.[57]

In its impact assessment of the new rules, the Inland Revenue suggested that the compliance costs for financial institutions were likely to be small:

> Businesses and public bodies that make savings income payments to, or collect savings income payments for, residents in certain other countries will have to report details on the individuals, and the payments made, to the Inland Revenue. This will include savings income payments by:
> - building societies, banks and other deposit-takers;
> - registrars, custodians and nominees;
> - authorised unit trusts and open-ended investment companies; and
> - any other person who makes savings income payments in the course of their business (for example, lawyers and stockbrokers).

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52 European Commission MEMO/04/52, 10 March 2004

53 "Swiss hitch may hold up introduction of EU savings tax", *Financial Times*, 3 June 2004

54 Council Decision 2004/587/EC of 19 July 2004.

55 European Commission press notice IP/04/1445, 7 December 2004

56 The regulations were made under s199 of the *Finance Act 2003*. This provision was not contentious when debated in Standing Committee (SC Deb B 17 June 2003 cc627-9), and subsequently the regulations were approved under the 'negative procedure' and without debate.

57 SC Deb A 20 May 2004 cc 343-6

> There are in the region of 600 banks, building societies, interest funds and other financial institutions that may be affected and range from small professional firms to large multinational financial institutions. For a sizeable proportion of these, however, the consequent costs would be negligible, as the small number of non-resident customers would make it unnecessary to incur the costs of information systems changeover …
>
> Based on feedback received from [consultation on the regulations] … we estimate that for most companies already required to report [this type of information under [existing provisions – specifically, ss 17&18 of the *Taxes Management Act 1970*] …changeover costs in the first year will range from zero or negligible for institutions such as lawyers, accountants and the financial institutions with very small numbers of foreign-resident individuals, to upwards of around £350,000 for the largest of institutions (although due to their large number of affected customers two or three institutions may have commensurately larger costs of several times this). After the introduction of the Directive, the ongoing additional costs are expected to be low and stable of the order of £10,000 to £20,000 per year, per institution, and much less for smaller operators.
>
> From the feedback we have received it is possible to say that small firms of solicitors and accountants do not hold money for many of their overseas clients. For those that do hold money, they seldom pay interest. For this reason the Directive is unlikely to impinge significantly on such firms. Feedback from the big four accountancy firms suggests that, having branches in all major cities, they do not tend to hold foreign residents' money either. In the few cases where they do, they are likely to report manually, rather than having a purpose built IT system. For these reasons we estimate compliance costs to lawyers and accountants whether large or small businesses to be either non-existent or negligible.[58]

In addition the UK completed a series of agreements to underpin the operation of the Directive with various non-EU territories: Aruba, Gibraltar, Guernsey, the Isle of Man, Jersey, Montserrat, the Netherlands Antilles and the Virgin Islands.[59] The then Paymaster General, Dawn Primarolo, gave some details on the implications of the Directive when the provisions relating the Channel Islands were debated in the House:

> For an initial transitional period—corresponding to the transitional period in the directive—Jersey, Guernsey and the Isle of Man will levy a tax on relevant payments, which their legislation calls a retention tax, unless the individual owner opts for the interest to be reported. The rate of the retention tax will initially be 15 per cent., rising to 20 per cent. in 2008 and to 35 per cent. in 2011. Income generated by the retention tax in each territory will be shared with the United Kingdom. United Kingdom individuals who receive savings income from Jersey, Guernsey and the Isle of Man will be able to elect to have their income paid without that reporting tax being applied. In addition, if they receive their income after deductions of withholding tax, they will get a full credit for that against United Kingdom income tax liability. If their liability is less than the amount withheld, the Inland Revenue will repay the difference.
>
> The United Kingdom will provide information automatically from the start of the agreement, but, at the end of the transitional period, both parties will apply full, automatic exchange of information in respect of the information covered by the agreement, although Jersey, Guernsey and the Isle of Man have the option to do so earlier if they wish.

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[58] *Full RIA : implementation of the European Union Savings Directive*, December 2003 paras 9, 27-8

[59] These agreements are contained in a series of statutory instruments. In the case of Jersey and Guernsey, these agreements are set out in SI 2005/1261 & SI 2005/1262.

The information will be passed in accordance with the strict rules that ensure, for example, that appropriate arrangements are in place to ensure the confidentiality of the information supplied. The reports will include details of the payments made, such as the amount of the payment and details of the account, security or fund concerned. Also, paying agents will have to report details of the identity and residence of the recipient. Different rules will apply depending on whether the contractual relationship between the paying agent and the individual started before or after 1 January 2004.

The Committee may be interested in how the text of each of the agreements, which are essentially identical, came about. Each agreement is based on a model text drawn up jointly by three territories for use with all 25 member states. After negotiations between the EU and the territories on aspects of the texts to ensure that, among other things, the agreement included the same measures as are contained in the directive, the model was unanimously approved by the EU Council of Ministers in 2004. The Council secretariat then drew up bilateral versions of the model for each member state to sign. Thus, Jersey, Guernsey and the Isle of Man are entering into 25 separate but identical bilateral agreements, of which the United Kingdom agreement is just one.[60]

The Savings Directive finally took effect on 1 July 2005; in a press notice issued at the time the Commission addressed a number of concerns about its impact – specifically, whether individuals would continue to evade tax simply by moving their savings out of the EU:

Is there not a risk that the Directive will cause European investors to use non-EU paying agents or to invest in securities outside the EU?
We believe not. Precisely because of the risk that the Directive could incite paying agent operations to relocate outside the EU, the EU has also concluded agreements on savings taxation with five key third countries and with the dependent and associated territories of the United Kingdom and the Netherlands.

The result is that paying agents of those countries and territories must apply the principles of the savings agreements to interest income from savings payable to EU residents. The EU's Council of Ministers after consideration has concluded that the bilateral arrangements that EU Member States have concluded with the United States of America are sufficient to enable EU Member States to apply their tax rules to their residents with savings in the United States. In addition, the Commission is, at the request of the Council, due to commence discussions shortly with other important financial centres with a view to providing for the adoption by those jurisdictions of measures equivalent to those to be applied within the EU.

Thus EU paying agents will be able to operate on an equal footing with their main competitors outside the Community.

Will the Directive and Agreements make it more attractive for European savers to invest in securities in other parts of the world?
No. For the purposes of the Directive and Agreements it will not matter whether the debt-claim giving rise to the interest were issued in a Member State or relevant third country or territory or elsewhere. Once the paying agent is located within the EU or relevant third country or territory, it will have to report on, or apply a withholding tax to, all interest, irrespective of the source of the related debt-claim, which it paid to an individual who was resident in an EU Member State. The Directive should not,

[60] Second Standing Committee on Delegated Legislation 14 March 2005 cc 3-5. Subsequently both the Isle of Man and Guernsey agreed to the automatic exchange of information from July 2011 (HC Deb 5 April 2011 c897W).

therefore, lead to a relocation of the securities issuing activities of European companies outside the EU or the third countries or territories with which savings agreements have been concluded.

The Commission also addressed the concern that the Directive's scope was too narrow to prevent individuals evading tax by putting savings in other investments or holding them in a different legal vehicle:

Are the Directive/Agreements too narrow in scope and will this allow investors to avoid the withholding tax or information exchange?
The Directive and Agreements apply to savings income in the form of interest payments. Other types of income such as dividends, income from insurance and pensions products and interest payments from certain grandfathered bonds have purposely been excluded from the Directive. The Commission will carefully monitor any substitution effects which may arise as a result of these choices and, if necessary, propose an appropriate extension of the scope

It is also possible that unintended loopholes may exist which will only become apparent when the parties involved have some practical experience of operating the arrangements.

But we do not believe that it is realistic to expect that every aspect of operating this Directive and these Agreements can be resolved with complete certainty before the arrangements take effect. If and when it becomes clear that there is scope for avoiding the application of the arrangements, the Commission will work with Member States to resolve these matters.

In fact, the Commission is required to report to the Council at least every three years on the operation of this Directive. Even before that, the Commission can and will propose to the Council any amendments that prove necessary in order better to ensure effective taxation of savings income and to remove undesirable distortions of competition. The Agreements with third countries and territories contain similar review clauses.

Why are interest payments made to companies (as opposed to individuals) excluded from the scope of the Directive/Agreements?
Because there are many more problems of tax evasion in the individual taxation area than in the company tax area. Companies are required to lodge annual tax returns and they are audited or are subject to the possibility of being audited on a regular basis. As far as companies are concerned, non-taxation of interest payments is not the main problem for tax administrations. The issue is more that of tax avoidance through aggressive tax planning. Some concerns have been expressed that individuals will claim to be representatives of companies in order to avoid the application of the Directive. The Commission hopes that Member States will, on the basis of the standards and rules laid down in this Directive, be able to establish the true identity of beneficiaries of interest and that the scope for tax evasion will be limited.[61]

[61] European Commission MEMO/05/228, *Savings Taxation: frequently asked questions*, 28 June 2005