**COUNCIL OF
THE EUROPEAN UNION**

Brussels, 5 March 2012

7254/12

FISC 35

COVER NOTE

from:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	2 March 2012
to:	Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union
No Cion doc.:	COM(2012) 65 final
Subject:	REPORT FROM THE COMMISSION TO THE COUNCIL in accordance with Article 18 of Council Directive 2003/48/EC on taxation of savings income in the form of interest payments

Delegations will find attached Commission document COM(2012) 65 final.

Encl.: COM(2012) 65 final

EUROPEAN COMMISSION

Brussels, 2.3.2012
COM(2012) 65 final

REPORT FROM THE COMMISSION TO THE COUNCIL

in accordance with Article 18 of Council Directive 2003/48/EC on taxation of savings income in the form of interest payments

{SWD(2012) 16 final}

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1. INTRODUCTION

Art. 18 of Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments (the "Savings Directive" or "Directive")[1] states that "*The Commission shall report to the Council every three years on the operation of this Directive. On the basis of these reports the Commission shall, where appropriate, propose to the Council any amendments to the Directive that prove necessary in order better to ensure effective taxation of savings income and to remove undesirable distortions of competition.*"

The report for the first review[2] was prepared in 2008 (the "2008 Report")[3] and covered the transposition and implementation of the Directive, summing up the economic evaluation[4] and the Commission's advice on the need for changes. The necessary changes identified in the 2008 Report were primarily meant to clarify certain interpretational issues and to close existing loopholes. To that end, the Commission adopted an amending proposal[5] on 13 November 2008 (the "Proposal") to the Directive with a view to closing existing loopholes and better preventing tax evasion.

The report for this second review primarily covers the functioning and an economic evaluation of the Directive. The main findings of this document, i.e. the widespread use of offshore jurisdictions for intermediary entities and the growth in key markets that provide products comparable to debt claims reinforce the arguments for extending the scope of the Directive and the relevant agreements concluded in accordance with Article 17 of the Directive. These findings are also consistent with the political commitment expressed by the G20 to promote compliance with international tax and financial information exchange

1 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:157:0038:0048:en:PDF

2 http://ec.europa.eu/taxation_customs/taxation/personal_tax/savings_tax/savings_directive_review/index en.htm

3 Report COM/2008/0552 http://eurlex.europa.eu/Result.do?T1=V5&T2=2008&T3=552&RechType=RECH_naturel&Submit=Search

4 Detailed in the Commission Staff Working Document presenting an economic evaluation of the effects of Council Directive 2003/48/EC on the basis of the available data, Brussels, 15.9.2008, SEC(2008) 2420 http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_tax/savings_directive_review/sec%282008%292420.pdf

5 Proposal for a Council Directive amending Directive 2003/48/EC on taxation of savings income in the form of interest payments, Brussels, 13.11.2008, COM(2008) 727 final, http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_tax/savings_directive_review/com%282008%29727_en.pdf

standards and to use all the countermeasures available to combat tax havens and non-cooperative jurisdictions that do not comply with these standards.

The Commission Staff Working Document accompanying this report provides more factual details of the subjects covered below.

2. TRANSPOSITION AND IMPLEMENTATION OF THE DIRECTIVE

In the first review, the Commission concluded that all Member States had transposed the Directive[6] and had started applying the implementing rules from the scheduled dates (i.e. 1 July 2005 and, for Bulgaria and Romania, 1 January 2007). The Commission has opened infringement procedures against individual Member States on specific elements of their implementing rules which were closed only after confirmation from them that such rules had been brought into line with the Directive. There are currently no pending infringement procedures.

At the ECOFIN Council meeting of 7 December 2010, the Commission committed itself to presenting an ad-hoc report by mid-2011 on the correct and effective application by Member States of the Directive. Based on the answers received to a questionnaire sent to all Member States, the Commission services compiled that report (SEC 2011 (775) Final[7]) which was transmitted to the Council on 14 June 2011.

An assessment of the replies from Member States suggests that certain of the Directive's provisions have been interpreted differently by Member States. Some of the risks of different interpretation thus highlighted had already been identified in the 2008 Report. In this context, the main problems would be removed through the corresponding new rules contained in the Proposal.

3. THE FUNCTIONING OF THE DIRECTIVE

The functioning of the Directive has been assessed by means of a questionnaire sent to the tax administrations of Member States concerning their use of the data exchanged under the Directive. In addition, the Commission has reviewed the statistics provided under the Directive and commissioned a study to assess the administrative burden of the existing Directive for economic operators. The main findings of the analysis are provided below.

3.1. Questionnaire on the use of data

A questionnaire was sent to the experts of the ACDT Group[8] concerning the use of the data received by their tax administrations from other Member States which included the following: the use of data for tax audits; the quality of data received from other Member States; and whether the introduction of the Directive had led to better compliance by tax payers.

6 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:72003L0048:EN:NOT#FIELD_BE

7 http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_tax/implementation/sec(2011)775_en.pdf

8 Commission expert group of national experts: Administrative Cooperation in Direct Taxation

Best practices

Member States that have carried out an assessment have reported positive compliance results. However, this review highlights some areas which Member States could improve in order to make better use of the information exchanged:

- integration of a savings directive database with the national tax database;
- development of risk management and more automated process of cross-checking the data;
- streamlining of the dissemination of data between the central tax administration and the local collection offices.

Quality of data

Member States have highlighted a clear increase in the quality of the data they receive due to the structured format and common rules of procedures under which the data are reported. By comparison with exchange of information under bilateral treaties, the quality of the data received under the Directive is significantly higher.

However, the quality of data received still remains a concern for many Member States. Currently, around half of the Member States confirmed that they conduct checks on the content of the information received from paying agents before sending them to the receiving Member States.

Given the importance of increasing the quality, all Member States should consider applying systematic checks on the quality of the information to be sent. In addition, Member States are encouraged to use an online checking system being developed by the Commission for the Tax Identification number (TIN) to correctly identify the taxpayer.

3.2. Statistics under the Directive

As the Directive had only been in operation since 01.07.2005, a lack of data restricted the scope of the first review. It was only in a Council meeting of 12.05.2008 that Member States agreed on the statistics[9] to be provided to the Commission in order to assess the efficiency and effectiveness of the Directive.

Since the first review, data definitions and formats have been defined which have led to better and more timely exchanges of information between Member States. Concerning the quantity of data exchanged, Member States that are large or with significant financial centres have exchanged the most information. The peak year for information exchanged was 2007 with reported transactions valued at EUR 38,9 billion (2009 figure[10]: EUR 9,9 billion). The inclusion of gross proceeds in the figures can lead to a different basis of comparison and if this element is excluded the amounts reported are more stable (interest income in 2009 is EUR 2,3 billion (2007: EUR 3,6 billion)). Withholding tax shared by all countries under the

9 http://register.consilium.europa.eu/pdf/en/08/st09/st09467.en08.pdf

10 Sweden did not submit data to the Commission on information exchanged with other Member States for all fiscal years. Ireland has had technical problems with its submission of data for 2009.

Directive and related Savings Agreements has decreased from EUR 700,9 million in 2008 to EUR 495,9 million in 2009. Both decreases in information exchanged and tax withheld can be partially explained by the financial crisis in the last quarter of 2008 which led to a significant fall in interest rates for household deposits in 2009.

A notable feature of the data is the high variability of the information exchanged by Member States during the period under review. A simulation exercise on ECB cross-border deposits (section 4 of this report) confirmed that for some Member States the interest payments amounts reported for the classical type of interest income were below the estimated benchmark for cross-border deposits and interest rates. Furthermore, replies from Member States to the ad-hoc report (section 2 of this report) indicated that most Member States rely primarily on the correct application of their guidelines by paying agents for the correct identification of relevant income to be reported, although they have provisions in place to perform audits and apply sanctions for non-compliance with the Directive.

To address the issue of variation of data exchanged across the fiscal years, Member States should consider the use of controls on the completeness of data submitted by their paying agents including the following: (i) a central register to be created by each Member State which lists paying agents established in their jurisdiction to verify whether data has been submitted when due; (ii) fluctuation analyses of data submitted by paying agents, in particular for amounts reported and the number of beneficial owners; (iii) cooperation between Member States in order to strengthen the audit procedures relating to paying agents including paying agents' systems and internal control guidelines; and (iv) the development of benchmarks and comparisons to other sources of data, for example national statistics on the reporting of cross-border deposits.

3.3. Evaluation of the start-up and recurring costs of implementation of the Directive

A study to assess the administrative burden of the existing Directive on economic operators concluded that information was already available to them for most reporting obligations under the existing Directive due to Anti-money laundering legislation[11], domestic legislation or internal business practices. However, none of the respondents indicated that they would collect information on Art. 4(2) (paying agent on receipt provisions) unless required to do so by the Directive.

Most steps in the reporting under the Directive are considered by the paying agents as "business as usual" costs and therefore the associated administrative burden seems not to be excessive.

[11] **Directive 2005/60/EC** of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (Text with EEA relevance)

4. ECONOMIC EVALUATION

As part of this review an economic evaluation was carried out in order to analyse the development of key EU and non-EU markets for savings products in terms of the importance of the relevant markets and the geographical structure of their client base. Bank reporting data were used from the Bank of International Settlements (BIS), the European Central Bank (ECB) and the Swiss National Bank (SNB). The ECB data were also used to perform a simulation exercise on the coverage of the potential base of exchange of information or withholding.

In addition, data on relevant specific markets – (1) bonds and shares (from the IMF CPIS), (2) debt and equity products and derivatives in general (from Eurostat), (3) structured retail products (from Avery), (4) UCITS (primarily from EFAMA) and (5) insurance products (primarily from a Europe Economics study) were used in order to analyse the development of those markets in recent years.

For the purposes of this report, the term UCITS is meant to refer to undertakings or entities authorised in accordance with Directive 2009/65/EC[12] (formerly Directive 85/611/EEC[13]). The terms non-UCITS and non-UCITS funds refer to all other collective investment funds or schemes.

The main findings of the evaluation are provided below.

BIS DATA

The International Locational Banking Statistics of the Bank for International Settlements (BIS) include quarterly data on assets and liabilities of domestic banks and branches of foreign banks situated in the 43 reporting countries broken down on a bilateral basis according to the vis-à-vis country of their foreign counterparts. The positions are reported on a gross and unconsolidated basis and in USD millions.

Most of the important offshore financial centres did not agree to the disclosure of their bilateral positions through BIS. However, publicly available BIS data, including the data on vis-à-vis countries[14], enabled a detailed analysis of offshore holdings with jurisdictions both in and outside the network of the Savings Agreements.

The publicly available BIS data indicated that the amount of foreign non-bank deposits for the Cayman Islands in 2011 is the second largest of the BIS reporting countries and comparable to that of the United States. The vis-à-vis results revealed that a significant share of the non-bank deposits in Member States, and in jurisdictions within the network of the Savings

[12] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 302, 17.11.2009, p. 32

[13] Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 375, 31.12.1985, p. 3

[14] All Member States, Switzerland and Guernsey agreed to the disclosure of their bilateral positions with all vis-à-vis countries, i.e. the countries of their deposit holders.

Agreements, are held by customers located in offshore jurisdictions (average of 35% for Member States and jurisdictions within the network of the Savings Agreements combined for the years 2000 – 2010; for the jurisdictions within the network of the Savings Agreements this share peaks at 65% in 2007)[15].

he relevance of offshore centres as a location for deposits and as place of establishment or management of non-bank deposit holder structures indicates that the implementation of look-through and paying agent upon receipt provisions for certain legal structures located in offshore jurisdictions is justified and necessary for both the Directive and the Savings Agreements.

15 It can reasonably be assumed that the non-bank sector in these jurisdictions do not consist primarily of industrial companies or individuals, but of intermediary entities.

ECB DATA

Coverage simulation

The data provided by the ECB is based on MFI[16] balance sheet statistics. Financial institutions in each Member State report to the ECB on a monthly basis the deposits held by non-resident households located in the euro-area. The amounts are reported for the aggregate euro-area without a detailed split among individual euro-area Member States. The data is split according to the sector of the deposit holder (including a detailed split for households) by seven different interest rate maturities. This data was selected as the best available on which to perform a simulation exercise in order to provide a limited evaluation of whether the data exchanged (or tax withheld) under the Directive reflect a satisfactory coverage of the potential tax base involved.

Using a 70% estimated coverage benchmark for the average data for fiscal years 2006-2009, 7 Member States fall below the 70% coverage benchmark while 4 others are below 100%. 16 Member States exceed 100%[17].

The results of the simulation exercise further support the need for Member States to consider the use of systematic controls on the completeness of data submitted by their paying agents as suggested in section 3.2

Evolution of cross-border deposits by euro-area households

The ECB data was also analysed to assess the evolution of cross-border deposits. Deposits from all maturities, including overnight deposits typically producing low interest, amounted to EUR 164 billion in 2003 and peaked at over EUR 247 billion in October 2008 (a 50% increase for the period).

Deposits with agreed maturity have decreased from EUR 72 billion in January 2003 to EUR 60 billion in November 2005 – 15% for the period and a monthly decrease of -0.52%. This is not replicated by the deposits without an agreed maturity (e.g. overnight deposits). A finer distinction between the trends for deposits with agreed maturity in the euro-area and the non-euro area Member States reveals that the downward trend until November 2005 came primarily from euro-area Member States (-38.84% for the period and a monthly decrease of -1.51%). During the following three years from November 2005 to November 2008 the two categories show an almost perfectly matched increase in cross-border deposits from EUR 60 billion to EUR 81 billion (an increase of 25% for the euro-area and 30% for the non-euro area respectively).

16 MFI: monetary financial institution

17 Results above 100% are normal as the definition of interest income in the Directive is wider than the deposits covered by the ECB data

After the end of 2008, deposits with agreed maturity in euro area Member States appear to have suffered the strongest decrease (from EUR 41 billion in November 2008 to EUR 21 billion in March 2010), primarily due to the financial crisis.

The trends for cross-border deposits of euro area households in other Member States show a general increase until the start of the financial crisis. The increase was primarily driven by deposits with no agreed maturity (e.g. overnight deposits with very low interest rates), whereas the deposits with agreed maturity (e.g. term savings accounts with higher interest rates) in euro-area Member States have decreased until November 2005, but recovered in line with deposits outside the euro area afterwards.

SNB DATA

The Swiss National Bank (SNB) issues an annual publication "Banks in Switzerland" which provides detailed statistics based on the financial reports of Swiss banks. Most importantly, the publication provides some detailed geographical and/or client breakdowns for the: (i) "Geographical breakdown of assets and liabilities shown in the balance sheet"; (ii) "Fiduciary business, by country"; and (iii) "Holdings of securities in bank custody accounts, by domicile of the custody account holder, the category of security and the business sector".

The results from the SNB data show a strong client base located in offshore jurisdictions both within and outside the network of Savings Agreements[18]. This confirms the urgent need (see also the above section devoted to BIS data) to address such cases where intermediary structures in offshore jurisdictions are involved in the payment of savings income by jurisdictions within the network of savings agreements and in particular the EU-Swiss Savings Tax Agreement.

IMF CPIS DATA

The IMF in its Coordinated Portfolio Investment survey (CPIS) reports cross-border investment positions (investment holdings at market prices prevailing at the year end) of investors resident in 74 participating countries (country of investor) with a split by the corresponding country of investment (country of issuer). The data is in principle compiled according to where the debtor (debt or equity issuer) and creditor (investor) is located which does not necessarily replicate the paying agent-beneficial owner status which is central to the functioning of the Directive.

[18] For example, fiduciary liabilities to (mainly non-bank) entities in the West Indies (For SNB and BIS purposes that includes Anguilla, Antigua and Barbuda, British Virgin Islands, Montserrat and St. Christopher/St. Kitts – Nevis) and Panama (with shares of 16% and 9% respectively) rank first and second as a share in all fiduciary liabilities.

Two major conclusions can be drawn from the CPIS data on the Member States that provide a detailed sectoral split:

The introduction of the Directive did not drive individual investors away from investing in securities issued in Member States and in particular those exchanging information. On the contrary, for most of the Member States surveyed, individuals increased their investment in securities in Member States, particularly those exchanging information; and

The Luxemburg investment funds industry has experienced a significant increase in its share of cross-border equity investments of households in the EU.

EUROSTAT DATA

Income

A comparison was made between income received by households compared to all sectors of the economy for income elements inside and outside the scope of the Directive to check whether there has been product substitution. The data revealed that, over the period 2000-2009, interest income received by EU households as a proportion of property income[19] was relatively stable until 2008 before falling sharply in 2009 due to lower interest rates received on debt claims following the financial crisis, a trend which also applies to the total economy.

No evident shift of the source of savings income towards products outside the scope of the Directive could be observed based on the Eurostat data on income[20].

Assets

An analysis of debt assets held by households revealed that these assets have been relatively stable over the period 2000-2009 compared to equity held by households which has almost halved over the same period, which may reflect the greater risk aversion of investors and/or a general decrease in the value of shares. A notable development is the large increase in financial derivatives held by households (1,05% of total households' assets in 1999 and 18,03% in 2009).

The increased use of financial derivatives would support an extension of the scope of the Directive to include structured financial products where the asset base is equivalent to debt claims.

STRUCTURED RETAIL PRODUCTS

The Commission made use of the Avery structured retail products database which contains detailed data on 34 markets and has over 2 million structured products launched worldwide. As of January 2005 the database is estimated to include around 90% of the structured retail products issued in Europe. The main limitation is that the database is designed for its clients'

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19 Property income: income derived from assets

20 It should be noted that a major limitation of the Eurostat data is that it does not differentiate between domestic and cross-border income, therefore only broad conclusions can be drawn.

marketing needs and does not distinguish for the Directive's purposes between domestic investments and cross-border investments. Nevertheless, irrespective of the lack of specific data on the cross-border element, the importance of this product market is demonstrated by the size of the market where the current outstanding amount of sales in covered EU markets is EUR 767,3 billion. This product market has undergone rapid development in general (an average annual increase of more than 30%) with a high proportion of products with capital protection features (dominating the launches in terms of volumes with a share of 60-70%) and interest-based underlying features (interest rate asset class share rose from 3.2% in 2001 to almost 30% in 2007).

The demonstrated importance of the structured products market and in particular of products similar to debt claims as well as the development of particular European markets that are primarily serving foreign retail investors justifies and supports the extension of the Directive and the Savings Agreements to include the types of structured products concerned.

UCITS data[21]

Regarding fund substitutability, data provided by EFAMA[22] reported a decrease in bond funds as a % of total UCITS (31% in 2002 – 23% in 2010) with an increase in investment in UCITS of other fund categories which were more likely to be outside the scope of Directive 2003/48/EC because of the composition of their assets. Similarly, there has been a shift to non-UCITS over the same period (22% in 2002 to 25% in 2010).

The increase of non-UCITS funds, although not necessarily driven by tax avoidance strategies, justifies the elements contained in the Proposal intended to bring about equal treatment of UCITS and non-UCITS funds having a comparable composition of assets.

INSURANCE PRODUCTS

Both data sources and anecdotal evidence suggest the appropriateness of the inclusion of life insurance products with an investment element within the scope of the Proposal. The PRIPS report[23] by Europe Economics identified the significance of unit linked life insurance as a proportion of the EU life insurance market, including Member States which have significant cross-border life insurance business with retail investors in the EU.

The development of significant cross-border markets for unit-linked life insurance products (considered as a distribution channel for UCITS) justifies the element contained in the Proposal according to which the Directive would extend to benefits from insurance products comparable to debt claims.

21 On the applicable definition, cf. page 6 above.

22 EFAMA: European Fund and Asset Management Association

23 Study on the Costs and Benefits of potential changes to distribution changes for Insurance Investment Products and other Non-MIFID packaged retail investment products. http://ec.europa.eu/internal_market/consultations/docs/2010/prips/costs_benefits_study_en.pdf

5. CONCLUSIONS

Member States have generally expressed their satisfaction with the data received under the Directive to ensure their taxpayers' compliance for the reporting of interest income. For the period under review, Member States have indicated a clear increase in the quality of the data received which they attribute to the structured format and common rules of procedures under which the data are reported. The review has also indicated how Member States can make better use of the data and demonstrated the necessity of further improving the correctness and completeness of the data exchanged.

The economic analysis has shown that the updating of the Directive and the relevant Savings Agreements, in terms of product scope as well as transactions and economic operators covered, is urgently needed in order to address the existing possibilities for circumvention, including those arising from triangular situations which involve jurisdictions both within and outside the scope of the Savings Agreements. A consensus on the Proposal and the adoption of a negotiating mandate for equivalent improvements in these Agreements are necessary in order to promote transparency and good governance in tax matters both within and outside the EU.