Taxation of savings income in the form of interest payments

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In June 2003 the European Union (EU) published a Directive on the taxation of savings income, which came into force on 1 July 2005 [(1)]. The aim of the Directive is to guarantee effective taxation of cross-border interest payments made to physical persons domiciled in the EU.

Two models coexist: automatic exchange of information, and withholding tax. The automatic exchange of information model provides that any financial institution deemed to be a paying agent forwards, via its tax authorities, all necessary information to the tax authorities of the EU country in which the beneficial owner is domiciled. Under the withholding tax model, applied in Austria, Belgium, Luxembourg and certain dependent and associated territories of the EU [(2)], the rate of withholding tax is 15% from 1 July 2005, 25% from 1 July 2008 and 35% from 1 July 2011.

Bilateral agreements with third states

The Directive also provides for a series of bilateral agreements with third states: Switzerland, Liechtenstein, Monaco, Andorra and San Marino [(3)]. As one of the issues covered by the bilateral negotiations between the EU and Switzerland, the taxation of savings income has led to an agreement that provides for a withholding tax collected by Swiss paying agents on interest payments made to European tax residents [(4)].

The Federal Tax Administration pays 75% of tax revenues to the relevant EU member states (based on a special distribution formula) while the remaining 25% is kept by the Swiss government. However, at the express request of a client, a Swiss paying agent must be able to apply the system of automatic exchange of information.

Challenges facing IT systems

Given the complexity of the Directive and the bilateral agreement between Switzerland and the EU, implementation represents a major challenge for paying agents, particularly from the standpoint of their computer applications. First, paying agents must precisely identify the actual beneficial owners, a concept that leaves room for endless legal squabbling. Second, they must obtain detailed information relating to interest paid on debt claims (in the widest sense) and by investment funds (which have invested in these debt claims). It goes without saying that, given the various national interpretations, the definition of interest gives rise to difficulties in practice.

Third, paying agents must make a retention at source and, in the case of automatic exchange of information, transfer all necessary data to the tax authorities. The cost of implementing the European taxation provisions in Switzerland are put at CHF 300 million, but this figure may well be below the actual cost.

Now that six months have passed since the Directive and the bilateral agreement came into force, it would be appropriate to review the contribution made by financial data providers. They have in fact been working away for some time at assessing what type of information is required by the Directive and the bilateral agreement and, as a result, supporting Swiss and European paying agents in their duty to identify the financial instruments affected.

The legal aspects underlying the implementation of the Directive and the bilateral agreement come outside the domain of data providers, as do the procedures for calculating the retention at source. Accordingly, they are not tackled in this article.

Not only do data providers have to take account of the viewpoints of both Swiss and European paying agents, but they also have to collect and distribute information in a standardized format that can be processed by computers with the greatest possible degree of automation. Put differently, the uniqueness, completeness and clarity of the flagging of financial instruments must be guaranteed, as must the flexibility needed in the event that regulatory provisions are amended. To these ends, data providers generally distinguish debt claims, hybrid financial instruments and investment funds.

Debt claims in all their forms

Debt claims comprise a wide variety of instruments: bonds, variable rate bills, money market papers, convertible bonds, medium-term notes and certain dividend-right certificates. In principle, all these instruments come within the scope of the Directive. However, with a view to determining their actual tax status, the rules as defined by the Directive and the bilateral agreement must be taken into account, namely: grandfathering [(5)], the issuing of further tranches and types of issuers, and exception for debtors domiciled in Switzerland.

European taxation has left its mark on the bond markets, as the following two examples show. The first affects supply and the second affects demand. On the one hand, under the text of the Directive, if a tranche of a security originally issued "by a Government" [(6)] before 1 March 2001 is issued on or after 1 March 2002, the entire issue ceases to benefit from the grandfathering rule. In other words, once a further tranche has been issued, all income paid by this debt security becomes taxable.

In addition, some states, including France and the United Kingdom, systematically issued "symbolic" further tranches at the start of March 2002. On the other hand, demand for grandfathered debt claims has grown in relative terms, chiefly because funds were set up to invest solely in this type of debt claim. On the whole, however, the mark left by European taxation on the bond markets would now appear to be fairly marginal.

Hybrid financial instruments

Hybrid financial instruments (i.e. option bonds and convertible bonds, instruments with capital protection, certificates, reverse convertibles, credit and disaster derivatives) may, by their design, combine features that result in interest payments subject to European taxation. The Federal Tax Administration categorized them, from the viewpoint of Swiss paying agents, into "subject" and "non-subject" in mid-May 2005.

With this in mind, the nature of interest payments needs to be examined. In general, interest is taxable if it is contractually guaranteed or it accrues on underlyings that are themselves affected by European taxation.

Pending further information, tax authorities other than the Swiss Federal Tax Administration – e.g. those in Germany, Austria and Luxembourg – are currently preparing their own classification. The coexistence of necessarily different national classifications complicates the work not only of issuers but also of data providers. As regards hybrid financial instruments, the taxation of savings may result in the increased creation of non-subject instruments, although this will have little or no effect on the markets.

Funds

As a general rule, trust funds and investment funds are subject to European taxation. However, given the application of the home country rule [(7)], the tax authorities of the domicile of the funds may decide, by simple decree, to regard them as not subject to European taxation. Such is the case, for example, with Part II SICAVs in Luxembourg.

As regards funds that are subject to European taxation, the determination of their actual tax status depends on their investment policy, which is measured using two thresholds, 40% and 15%, both of which are tested on the basis of direct and indirect investments in assets affected by European taxation. On the one hand, exceeding the 40% threshold results in the taxation of the portion of interest contained in the sale or redemption proceeds. Under the terms of the Directive, the 40% threshold will be cut to 25% after the transitional period, i.e. from 1 January 2011. On the other hand, exceeding the 15% threshold means that only the portion of interest contained in the distribution is taxable. Below this threshold, the portion of interest is not taxable.

Thus two indicators are necessary for each fund subject to European taxation: one for distributions and the other for sale or redemption proceeds [(8)]. In that way, each paying agent knows exactly the type of income paid by a fund that it is required – where appropriate – to tax.

Difference between Directive and bilateral agreement

Here it is important to stress a major difference between the Directive and the bilateral agreement. The Directive provides that each EU member state may decide to apply the 15% threshold for funds domiciled on its territory. Such a decision is then binding on all other member states, but not on third states. In other words, this is an option that some countries (like France) have not exercised, giving rise to a potential competitive disadvantage.

On the other hand, the bilateral agreement sets down the 15% threshold as a general rule, independently of the domicile of the funds. Consequently, the distribution of a fund that is domiciled in France and has invested less than 15% in affected assets will be taxed in Luxembourg but not in Switzerland. The same financial instrument may therefore entail different tax effects depending on the domicile of the paying agents.

A Swiss bank with branches in the EU must therefore be able to make such a distinction. In terms of computer applications, if such a bank supplies its European branches with financial data from Switzerland, it must be able to process differentiated information.

Necessity of providing information

It is the responsibility of the fund managers themselves, and not the data providers, to indicate the tax categorization, calculate the actual percentage of investments in affected assets and deliver the portion of interest in the distributions and the portion of capitalized interest contained in the net asset value, in accordance with the Swiss and European viewpoints.

Such a task is not only necessary for a precise tax categorization but also useful for managers of funds of funds, who have to carry out different calculations. If, for one reason or another, an investment fund decides not to deliver any information, it automatically comes within the least favourable tax category: the whole of the distribution and the positive difference between the sale or redemption price and the acquisition price. If, contrary to all expectations, the acquisition price is missing, the totality of the sale or redemption proceeds would be taxable. Thus it is in the interests of investment funds and paying agents for all information to be transmitted to data providers.

Effects of European taxation on the industry

European taxation could well have far-reaching consequences for the investment fund industry. Apart from the creation of funds that invest in non-taxable debt claims, there may be other reactions. First, fund managers who invest between 15% and 40% in affected assets may give up making distributions. In this category, distributions are taxable but sale or redemption proceeds are not.

Second, fund managers may decide only to target institutional clients. Third, regulatory arbitrage may emerge that permits a fund to escape European taxation. A simple but efficient mechanism would consist, for example, in changing the domicile of the fund with a view to benefiting from a regulatory exemption or the de minimis rule (15%).

Fourth, the necessity for fund managers to provide detailed information (i.e. asset tests, portion of interest contained in distributions, portion of capitalized interest in net asset value) for fear of going into the least favourable tax categorization generates administrative costs that could weaken the performance achieved, resulting in a market shakeout. While there are many ways in which fund managers may react, it is nonetheless still too early to assess the actual impact of European taxation on the fund management industry.

Highly complex provisions

Implementation of the Directive and the bilateral agreement does not fundamentally alter the tasks of data providers, i.e. the procurement, processing and distribution of characteristics, securities transactions, market data and valuation prices. In fact, the difficulty consists in taking account of the complexity of European regulatory provisions, their national interpretation and the specific aspects of the bilateral agreement between Switzerland and the EU.

That said, the Directive itself provides for a review of its implementation in the EU member states. This is because there are still some divergences that could lead, in practice, to regulatory arbitrage that

would go against the objectives of the EU. It would therefore come as no surprise if the regulatory framework were strengthened or national interpretations harmonized. For example, it is not difficult to imagine a desire to include within the Directive's territorial scope jurisdictions that are currently spared (such as Singapore), to redefine the notion of the beneficial owner and thereby extend it to legal entities, or indeed to take account of payments made by a wider range of financial instruments.

Whatever the case, there can be no doubt that data providers will, if necessary, be able to incorporate any amendments to the regulatory provisions.

Key role of Telekurs Financial Information Ltd.

As an international data provider, Telekurs Financial Information Ltd. has been involved from an early stage in the implementation of European taxation. When devising its solution, it participated in the various working groups of the Swiss Bankers Association (SBA). To take account of the European dimension of its approach, it established contacts with the Luxembourg Bankers' Association (ABBL), the Association of the Luxembourg Fund Industry (ALFI) and the European Banking Federation (FBE). In Switzerland, Telekurs Financial Information Ltd. is now an official data provider authorized by the Federal Tax Administration.

The database of Telekurs Financial Information Ltd. covers some 2.5 million financial instruments. Among the 1.7 million active instruments, 38% come within the scope of European taxation (debt claims 57%, hybrids 13% and investment funds 30%). In reply to a questionnaire at the end of December 2005, around 55,800 investment funds – the vast majority of which are domiciled in Switzerland – gave Telekurs Financial Information Ltd. all the information needed for a precise tax classification.

However, given the large number of investment funds and structured products still "unknown" to this day, designation proceedings have been instituted, chaired by the Federal Tax Administration (FTA) and bringing together representatives of the Swiss Bankers Association (SBA) and the Swiss Funds Association (SFA). Its task is, first, to assess the issuing prospectuses of the funds and structured products for which no questionnaire has so far been returned and, second, to grant them, if necessary, the status of "not subject" to European taxation. Of course, such a tax classification is only binding on Swiss paying agents. Telekurs Financial Information Ltd. will then flag the financial instruments in its database.

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(1) Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments.

(2) Netherlands Antilles, Guernsey, Isle of Man, Turks and Caicos Islands, British Virgin Islands and Jersey. The other dependent and associated territories, i.e. Anguilla, Aruba, Cayman Islands and Montserrat, have opted for the automatic exchange of information.

(3) Liechtenstein, Monaco, Andorra and San Marino have modelled their agreements on that concluded between the EU and Switzerland.

(4) On 11 May 2005, the Federal Council decided that the bilateral agreement of 26 October 2004 and the concomitant federal law of 17 December 2004 would apply as from 1 July 2005 (cf. www.estv.admin.ch). Apart from the taxation of savings income in the form of interest payments, the bilateral agreement contains provisions relating to administrative assistance in case of tax fraud or equivalent offences (i.e. exchange of information on request) and the elimination of taxation at source of cross-border payments in the form of dividends, interest and royalty payments between associated companies. These two subjects are not covered by this article.

(5) The grandfathering rule provides that interest income on debt claims issued before 1 March 2001 is not taxed. It is transitional in nature until the end of 2010. If a new tranche of a government debt security is issued on or after 1 March 2002, revenues deriving from such security will be taxed. For a private debt security, only the additional tranche is taxed provided it is clearly identifiable (i.e. it is allocated a specific identifier in the form of a securities number or ISIN).

(6) The notion of "government" applies to government debt securities and debt securities issued by the entities explicitly mentioned in the Directive.

(7) This refers to the fact that a decision by an EU member state to make something subject to tax applies *de jure* and *de facto* to all EU member states. However, this rule is not binding on third states with respect to EU members.

(8) For an accumulation fund, the "taxable distribution" indicator is negative, irrespective of the percentage of investments in assets affected by European taxation.

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