Bulletin

Allgemeines Treuunternehmen
No. 12 – January 2005

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EU TAXATION OF SAVINGS INCOME

I. INTRODUCTION

The "agreement between the European Union and Switzerland on regulations equivalent to those set out in the Council directive 2003/48/EC dated 3 June 2003 relating to the taxation of savings income" was initialled by the representatives of the contracting parties on 25 June 2004 and signed at the end of October 2004. The Swiss Integration Office DFA/DEA has published its explanatory notes on the public consultation stage in respect of the agreement [1].

As a result of a decision by the Federal Council dated 18 August 2004, the Federal Department of Finance (FDF) also published the draft for a "Federal act relating to the taxation of savings income agreement with the European Union" (Taxation of Savings Income Act, "ZBstG") on 18 August 2004 and set the procedure for the discussion stage in motion. The deadline for the submission of written comments expired on 10 September 2004.

Finally, on 19 October 2004 the "draft of a guideline on the EU taxation of savings income" was published on the Homepage of the Swiss Federal Tax Administration, Main Division for Federal Direct Tax, Anticipatory Tax and Stamp Duty (DAS) and the procedure for the public consultation stage set in motion.[2] The period for the submission of written comments expired on 30 November 2004. This draft guideline is of course subject to the agreement between the European Union and Switzerland coming into force.

The "agreement between the European Union and the Principality of Liechtenstein on regulations equivalent to those laid down in the Council directive 2003/48/EC dated 3 June 2003 relating to the taxation of savings income" was initialled by the representatives of the contracting parties on 30 July 2004. The agreement was signed on 7 December 2004.

Draft implementing legislation has not yet been drawn up. Discussions in this respect are currently being held between representatives of the government as well as the associations of professional and financial organisations.

It is likely to be the view of all participants that the Swiss measures for implementing the taxation of savings income agreement ("ZEB") will to a significant extent be able to serve as a model. This view is also supported by the fact that as financial centres Switzerland and Liechtenstein traditionally maintain very close links. In addition to this, there is the fact that in the structure of key regulations Switzerland has also taken on "a specific role as a forerunner" for other third states affected and to some extent even for the European Union directive.

Against this background, when replying to the question as to what consequences the complex "EU taxation of savings income" and the resultant statutory regulations will have for the Principality of Liechtenstein as a financial centre, it appears right and proper and in fact imperative to essentially follow the example of Switzerland in the implementation regulations, in particular the draft for the law on the taxation of savings income ("ZBstG") and the draft for a guideline on the EU taxation of savings income.

There will however be areas in which the structure of Liechtenstein as a financial centre, the differing legal preconditions as well as the deviations from the texts of the agreement, will require differing implementation measures, including for those areas in which it is not possible for the regula-

tions in Switzerland to serve as a basis. This concerns in particular the areas of the measures taken to document the paying agents (as per Article 6[3]) on the one side and the regulations in respect of the exchange of information (as per Article 10) on the other. This article will therefore also need to look in particular at these special features in the implementation of the agreement with and in the Principality of Liechtenstein.

II. THE OBJECTIVE OF THE AGREEMENT

The starting point for the agreements with Switzerland and other third states[4] on regulations equivalent to those laid down in the Council directive 2003/48/EC dated 3 June 2003 relating to the taxation of savings income, was the passing of the European Union directive on 3 June 2003 and its efforts to incorporate third states not directly covered by the directive's regulations in such a way that these countries are able to introduce "equivalent measures" in order to prevent the EU taxation of savings income being circumvented via these above-mentioned countries.

By implementing these "equivalent measures" the third states are providing a form of procedural assistance aimed at safeguarding the taxation of savings income within the EU by introducing tax retention measures to create an instrument the aim of which is to avoid the taxation of savings income in the EU being circumvented. The system of EU taxation of savings income is consequently de facto extended to the sovereign territory of the third states.

Like the system of subject-specific tax retention in the case of withholding tax in Switzerland, the objective is to guarantee the taxation of savings income in the EU through the concept of subject-specific tax retention through the introduction of a tax obligation on the part of the paying agent.

III. KEY ELEMENTS OF THE SYSTEM

1. The period of validity

The system of EU taxation of savings income, i.e. both the directive as well as the agreement, is intended to come into force on 1 July 2005 and be valid for an unspecified period.

The tax retention rate, commencing from the date on which the agreement comes into effect, 1 July 2005, will be 15% in the first three years, i.e. up to 30 June 2008, 20% in the subsequent three years, i.e. from 1 July 2008 to 30 June 2011 and 35% from the seventh year, i.e. from 1 July 2011.

Interest payments arising prior to 1 July 2005 will not be subject to the system of the EU taxation of savings income, even if they are not credited or paid until after the regulations come into force.

2. The person affected

The deciding factor in the taxation is the taxable party, i.e. the individual being the recipient of the interest payment. The agreements and the directive set out criteria that must be met for a recipient of an interest payment to qualify as a "beneficial owner of interest" as understood by the regulations. Accordingly, the following requirements must be met:

- this must involve a natural person;
- this person must be domiciled in a member state of the EU;
- he/she must receive an interest payment as understood by the regulation;
- and he/she must be entitled to beneficial ownership of this interest payment.

The above-mentioned criteria must be met on a cumulative basis. If just one of these criteria is not fulfilled then directive and agreements do not apply.

Interest payments to corporate entities are basically not covered by the directive or the agreements.

a) Differentiation between natural person / corporate entity

No distinction from the viewpoint of legal dogma will be made here between natural persons and corporate entities. A corporate entity (juridical person) is a legal entity which is recognised in law as having legal capacity, i.e. can itself possess rights and obligations. Corporate entities are not covered by directive or agreements.

The draft from the Swiss Federal Tax Administration for a guideline on the EU taxation of savings income contains a list of a number of key corporate entities which, whilst not being exhaustive, not only contains various corporate entities in Switzerland and other jurisdictions but also the legal forms of the Principality of Liechtenstein, i.e. the company limited by shares, the foundation as well as the establishment[5]. This shows that the system of EU taxation of savings income is fundamentally not applicable to the above-mentioned legal entities.

The owners of a corporate entity, i.e. the partners, shareholders or such like are irrelevant to the system of EU taxation of savings income, even if these are natural persons. This even applies if the beneficial owner has been identified or ascertained in accordance with the per-

tinent regulations aimed at preventing money laundering.

The provisions relating to the treatment of trusts, in connection with which the trustee regularly acts as the contracting party, have to-date not yet been definitively formulated.

b) The criterion for domicile in the EU

With regard to the requirement for domicile in the EU it must be noted that this must be ascertained and documented in any event by banks and other financial service providers in connection with the enquiries made on the basis of the respective, pertinent regulations for preventing money laundering relating to the identity of the beneficial owners of specific assets and the earnings derived from them. The beneficial owner's place of domicile is taken from the details on the contracting party. There is no obligation on the part of the paying agent to carry out further enquiries.

Unlike the paying agents in the EU the paying agents in Switzerland and in the other third states apply the respective, relevant "know-your-customer rules" (KYC rules) both for accounts that were opened prior to 1 January 2004 as well as for those that were opened after 1 January 2004 for ascertaining the identity of the recipient being the beneficial owner of the interest[6]. For client relationships opened after 1 January 2004 and for transactions ordered after this date, the paying agents in Switzerland and the other third states will only request a tax resident's certificate from the respective competent authorities in the country of domicile in those cases in which the recipient of the interest being the beneficial owner identifies him/herself as a citizen of an EU member state and simultaneously states that he/she is not domiciled in the EU or Switzerland. If no such certificate can be furnished then the recipient of the interest, as the beneficial owner, must be treated as being domiciled in that EU member state of which he/she provides identification of citizenship[7].

c) The criterion for the rights to beneficial ownership

With regard to the requirement for the rights to beneficial ownership it must be noted that the observations by the banks and other financial service providers regarding the beneficial owners of specific assets and the earnings derived from these, made on the basis of the respective, pertinent regulations relating to the prevention of money laundering, are fundamentally of no relevance in connection with the agreement[8]. The details on the individual being the recipient of the interest with the rights of beneficial ownership as defined in the agreement must be recorded irrespectively of this. The regular outcome of this however will be the details on the beneficial owner being the same as those which have to be recorded under Article 4.

In principle, the paying agent may assume that the contracting party (counter party) and the person entitled to beneficial ownership are one and the same person. There is no obligation on the part of the paying agent to proactively obtain information on the question as to whether the contracting partner and the person entitled to beneficial ownership are one and the same person, e.g. by requiring all contracting partners to complete a declaration on the entitlement to beneficial ownership as understood by the agreement.
There are two possible exceptions from this basic principle:

- If the contracting party contradicts the assumption that he/she is personally entitled to beneficial ownership then he/she must prove who is the actual person entitled to beneficial ownership under the directive and/or the agreement, or must provide the evidence that he/she is to be personally seen as the paying agent.
  If the contradiction from the contracting party is submitted retrospectively, i.e. after the business relationship has been opened, then it shall be effective on receipt of the declaration by the paying agent. There is fundamentally no provision for retrospective effect. However, this can be accepted by the paying agent on the basis of goodwill towards the contracting party.

- If there are bases and/or is information available suggesting that the recipient of the interest payment is not the person entitled to beneficial ownership, then the paying agent must take appropriate steps to ascertain the identity of the person entitled to beneficial ownership.

  This duty to clarify the situation applies in those cases in which there is either documentary proof that the contracting party (natural person) is not the beneficial owner, a beneficial ownership relationship is documented in writing or reference in writing to a fiduciary relationship is provided.

In all other cases, the basic principle above, under which it can be assumed that the contracting party (counter party) and the person entitled to beneficial ownership are one and the same person, shall apply.

3. Interest

The definition of interest is extensively covered both in the agreements and

equally in the directive, encompassing on the one side interest directly associated with debt claims (direct interest) and, on the other, interest also earned indirectly (indirect interest) through investments in specific joint investments (investment funds). Which interest payments are covered by the directive and the agreements and which are not is dealt with in detail and definitively in the above-mentioned draft guideline on the EU taxation of savings income, reference to more detailed literature on which is made here.

The definition of interest in the EU system of taxation of savings income does not cover payments arising from participation rights (dividends) payments arising from insurance policies, benefits from pension schemes as well as other benefits which are not based on any debt claim relationship.

The interest debtor's place of domicile is irrelevant to the EU system of taxation of savings income. The only exception to this is Swiss interest debtors, insofar as interest which is based on debt claims against debtors domiciled in Switzerland or relates to Swiss business operations of persons not domiciled in Switzerland is excluded from the EU taxation of savings income. This exemption applies in particular to interest on client credit balances in savings accounts, rental guarantee bonds etc. as well as to medium term notes and bonds issued by banks. The Swiss withholding tax levied on such interest payments supersedes the tax retention based on the directive and the agreements.

4. The paying agent

The paying agent as understood by the agreements is defined in their Article 6. On the one side the definition explicitly lists specific beneficial owners such as banks and traders in securities as paying agents and, on the other, contains an all-embracing statement for "other paying agents" in the form of a general clause.

The key characteristic of the paying agent in the EU system of taxation of savings income is that this party acts for third parties and their assets and not for themselves or their own assets. Those qualifying as paying agents as understood by the agreements are shown below using the examples of the Swiss and Liechtenstein agreement:

- banks as understood by the Federal Banking and Savings Institutions Act ("BankG")[9],
- traders in securities as understood by the Federal Stock Exchange and Securities Trading Act ("BEHG")[10] as well as
- natural persons and corporate entities with place of domicile and/or registered offices in Switzerland or another third state, as well as partnerships and business operations of foreign companies which accept, hold, invest or transfer assets of third parties or only pay out or accumulate interest as part of their business activity, at least on an occasional basis ("other paying agents" as understood by Article 6).

The text of the agreement with the Principality of Liechtenstein provides for a special feature here insofar as the economic operators governed by the Liechtenstein Persons and Company Law (PGR) are expressly included within the scope of the agreement. To what extent this relates to domiciliary companies such as companies limited by shares, foundations, establishments etc. will also be the subject of the comments made below.

a) Banks and traders in securities

It is not intended to go into further detail on the banks and traders in securities at this point. This group of paying agents will not raise any problems of interpretation. The definitions are derived from the stated statutory regulations of Switzerland as well as the other third states.

b) "Other paying agents" (all-embracing statement)

The "other paying agents" include in particular fund managements, insurance schemes, asset managers, trustees, lawyers and notaries as well as companies and business operations of foreign companies that regularly or only occasionally hold interest-bearing investments for natural persons entitled to beneficial ownership and domiciled in an EU member state, or which pay interest on loans for which they are not personally the debtors.

Accordingly, only a party that transacts commercial business can be a paying agent. Any party which acts on a non-commercial basis, purely within the framework of his/her private domain, does not qualify as an "other paying agent" as understood by the agreements.

The definition therefore appears to be clearly aimed at professional paying agents and paying agents acting for third parties and their assets. The question that this raises in respect of the treatment of domiciliary companies and foundations governed by the Liechtenstein Persons and Company Law (PGR) can therefore be answered with relative clarity. Specific Liechtenstein legal entities (in particular property assets with a separate legal identity such as foundations and establishments) are eo ipso

not covered by the definition of a paying agent as these do not fundamentally act for third parties within the framework of their normal purpose but instead basically for themselves, providing they are constituted and operate in accordance with the law.

A corporate entity therefore acquires the function of a paying agent if it is not the legal entity itself but a third party who has a direct entitlement to the claim for interest payment as understood by the agreement. An example of the latter alternative would be the case in which reference accounts are held in the name of the legal entity for individual shareholders or beneficiaries.

It must be stated in this respect that when drafting the statutes e.g. of a foundation under the Liechtenstein PGR it must be assumed in principle that this foundation manages and acquires its assets and the earnings arising therefrom for its own benefit and not for that of third parties. Such a foundation is therefore not to be seen as a paying agent as understood by the directive and the agreements.

However, caution is called for in cases in which founder and/or beneficiaries reserve or grant themselves certain access and decision-making rights over and above the existing statutory rights (right to give instructions to the Foundation Board, signatory right to the foundation account, mandate agreement, right of revocation etc.) to the assets of the foundation and the earnings derived therefrom.

c) Absence of a misuse and/or "look-through" clause

Unlike the directive, as contained in Article 4 Para. 2, in the Liechtenstein agreement, as in the Swiss agreement, there is no clause on the so-called "entities". This also helped avoid a potential source of confusion and a need for interpretation.

5. Legal assistance and exchange of information

The clauses relating to the exchange of information and the requirements for this are contained respectively in Article 10 of the agreements.

For the interest earnings covered by the agreement between Switzerland and the EU, Switzerland and the member states of the EU exchange information in accordance with the procedure provided for within the framework of the double taxation agreement between Switzerland and the member states in respect of actions which represent tax fraud or the like under the legal regulations of the petitioned state. Offences considered as "the like" are exclusively those which constitute the same unlawful activity as tax fraud under the legal regulations of the petitioned state. Categories of cases which are to be classed in the participating states as "the like" offences as understood by the agreement should be defined in bilateral negotiations between Switzerland and the member states of the EU. More detailed information on this, e.g. from the Swiss Federal Tax Administration, is not yet available.

In its draft for a "Federal act relating to the taxation of savings income agreement with the European Union" (Taxation of Savings Income Act, "ZBstG"), in chapter three Switzerland makes express provision for administrative assistance which is to be verified and, if necessary, rendered in the individual case by the Swiss Federal Tax Administration. This represents a significant difference from the solution provided for in the Principality of Liechtenstein.

Provision for an exchange of information in respect of interest earnings covered by the agreement between the Principality of Liechtenstein and the EU is expressly made only in the form of legal assistance. This is expressed in the wording contained in Article 10 Para. 2 of the agreement "(…) shall provide in accordance with its procedural laws information (…)". In the Principality of Liechtenstein provision for enforcement measures and lifting of banking secrecy is made only in the law on international legal assistance in criminal matters (Legal Assistance Act, "RHG") and in the Criminal Proceedings Ordinance ("StPO"). This means that the standard procedure for legal assistance in respect of the exchange of information as understood by the agreement will have to be implemented or run through.

In the consultations held by the Liechtenstein legislators, the considerations in respect of the implementation of Article 10 of the agreement state to the effect that the official department responsible for implementing the agreement could be responsible for receiving petitions as understood by Article 10 and that this department could also conduct a preliminary examination in accordance with the Swiss clause in Article 14 Para. 2 of the draft act. If the examination reveals that enforcement measures are necessary or that banking secrecy should be lifted in the specific individual case, then the authorities must forward the petition to the Justice Department as the central authority for matters relating to legal assistance. This department will then set in motion the standard procedure for matters relating to legal assistance.

As in the agreement with Switzerland, Article 10 Para. 4 of the agreement stipulates that categories of cases which are to be classed in the participating states as "the like" offences as understood by the agreement, are to be defined in bilateral negotiations between the Principality of Liechtenstein and the member states of the EU.

Express provision is made in the agreement ("(…) conduct constituting tax fraud (…), for income covered by this agreement (…)") that Article 10 shall only apply to cases of fraud or the like in respect of earnings from interest only earned after the date the agreement came into force. The Liechtenstein legislators are however considering providing a clear definition of the chronological and material scope of Article 10. The reason for this is that in theory there is the possibility of earlier events, occurring prior to the agreement coming into force, also being covered by the legal assistance in order to evaluate a specific criminal offence. Consideration is being given, for example in cases in which the subject is repeated offences, to excluding from the scope of Article 10 those individual actions which occurred prior to the agreement coming into force. There is currently no further detailed information available on this.

IV. CONCLUSIONS

In conclusion, it can be stated that the agreement between the Principality of Liechtenstein and the EU has been modelled extensively on the agreement between Switzerland and the EU and that, apart from a few exceptions, the texts are virtually identical. As the forerunner in this, thanks must be expressed to Switzerland for the fact that it has succeeded in putting forward and asserting the viewpoint under which an effective taxation of savings income is not necessarily dependent upon the automatic exchange of information between the participating states. It can certainly be stated that agreeing these clauses has enabled the future of banking secrecy to initially be secured for the time being.

The author of this Article, Mr. Thomas M. Schulz, Lawyer, M.B.L.-HSG, at Allgemeines Treuunternehmen is at your disposal should you require further information.

[1] See www.europa.admin.ch/nbv/off/vernehm/d/tax.pdf
[2] See www.estv.admin.ch
[3] Information on articles without any additional description always refers to those of the agreement between the Principality of Liechtenstein and the EU.
[4] Principality of Andorra, Principality of Liechtenstein, Principality of Monaco and Republic of San Marino.
[5] See "Draft of a Guideline on EU Taxation of Savings Income" dated 19 October 2004, see under www.estv.admin.ch
[6] See Article 5 sentence 1 of the agreement
[7] See Article 5 sentences 2 and 3 of the agreement.
[8] Charles Hermann and Georges Bock, KPMG Financial Services Tax Group, "The EU Saving Directive in the EU and in Switzerland", Presentation in Luxembourg on 20 May 2003.
[9] AS 51 117 and BS 10 337, Federal Banking and Savings Institutions Act (Banking Act," BankG") dated 8 November 1934 (status as at 28 September 1999).
[10] AS 1997 68, Federal Stock Exchange and Securities Trading Act (Stock Exchange Act, "BEHG") dated 24 March 1995 (status as at 28 September 1999).

Allgemeines Treuunternehmen

Aeulestrasse 5
P. O. Box 83
FL-9490 Vaduz
Principality of Liechtenstein

Telephone +(423) 237 34 34
Fax +(423) 237 34 60
Internet www.atu.li

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