



Plugging the gaps

Reform of the EU Savings Tax Directive

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Summary

This report has been prepared by Richard Murphy on behalf of Tax Research LLP and the Tax Justice Network International Secretariat (collectively 'we' in this report).

We welcome the planned revisions to the EU Savings Tax Directive (STD) announced on 13 November 2008 subject to the observations made in the report.

We recognise that the STD has one objective, which is to reduce tax evasion. That is the criteria we use for assessment of the proposed changes.

This report notes the often overlooked success of the existing STD. Despite its deficiencies, many of which have been accurately noted in the documentation supporting the proposed changes, it has made a significant contribution to the process of tackling tax evasion, most notably by being a multilateral agreement on that issue, by pioneering bulk information exchange and by including a number of recognised tax havens and third party states in the agreement.

We broadly welcome the proposed changes to the STD. They are targeted at the most flagrant existing abuses of the STD. They are pragmatic.

¹ Thanks are noted to Markus Meinzer of the Tax Justice Network for comment and input into this paper

² The opinions reflect those of the Tax Justice Network International Secretariat and not necessarily those of all Tax Justice Network affiliate organisations

We accept that at this stage it would be difficult to extend the STD to all legal persons and to all forms of capital income. That said, a commitment to do so in the future would seem to be an important part of the process of reform and should therefore be included in the revised STD.

The current STD includes a transitional arrangement applicable in some participating jurisdictions allowing tax to be withheld from interest payments made to recipients to whom the STD applies and who do not wish to exchange information on the income earned with their country of residence. It is apparent that this facility has allowed continuing evasion of tax by some of those exercising this option to refuse the exchange of information. Transitional arrangements should always come to an end and we would encourage the Commission to publish a date on which this option will cease to be available so that full automatic information exchange will apply in every participating jurisdiction.

The proposed changes to include legal entities and arrangements (mainly trusts) in the scope of STD, to broaden the definition of interest income, to restrict the use of non-UCIT³ structures, to change the definition of ‘paying agent on receipt’ (PAOR), to consider certain structures as ‘tax transparent’ and to therefore treat them as agents for their beneficial owners and to positively identify those structures that will be treated as PAORs and as tax transparent are all particularly welcomed.

All this being noted, we have significant concerns about some aspects of the proposed reform of the STD. These particularly relate to Annexes 1 and Annex 3 to the proposed STD. As currently drafted they are incomplete, failing to list all relevant jurisdictions and a significant number of entities that should be automatically considered as either PAORs or as tax transparent, and they create the possibility for significant political tension both prior to adoption of the proposed STD and after its implementation whilst providing ample opportunity for future tax avoidance and evasion, so undermining the objectives for which they were created. As a result we make suggestion in this report for additions to the list of jurisdictions to be covered, demonstrate the weaknesses in the drafting of Annex 3 and suggest an entirely different approach to defining entities to be considered tax transparent in Annex 1 which is likely to result in substantial enhancement in the effectiveness of the proposed STD.

We also note that the effectiveness of many of the arrangements proposed are dependent upon the anti-money laundering (AML) ‘know you client’ (KYC) procedures used to determine the residence of the beneficial owners of entities and arrangements now to be included within the scope of the STD. We have doubt about the reliability of those AML KYC procedures when used for this purpose. This is because the risk based approach to KYC rules permitted by the 3rd European Money Laundering Directive and under Financial Action Task Force

³ Undertakings for Collective Investment in Transferable Securities

rules has resulted in some jurisdictions considering the opening of some interest bearing deposit accounts as a transaction carrying low risk, for which purpose only a single document KYC identification process is required. When a passport is used for this purpose the regulated organisation that might for STD purposes become either an upstream economic entity or a paying agent may hold insufficient information to determine the place of residence of the taxpayer to whom a payment is made, so undermining a critical element of the STD. For this reason we recommend a revision to the rules on client identification to be used by paying agents for STD purposes to avoid doubt arising.

Finally, whilst noting that it was not the intention to extend the STD to all capital income, it is clear that some extension of the definition of interest to include a broader range of life assurance products, annuities, swaps and some pensions may have been helpful and if none can be included in this version of the STD then we recommend that extension to these types of income must be indicated as areas for future attention as part of a programme of ongoing work of revision of the STD.

Introduction - tax evasion is the issue

As the EU notes on its own website:

Income from interest on capital is one of the most mobile tax bases, and tax competition is rife. In order to ensure the proper operation of the internal market and tackle the problem of tax evasion the savings tax Directive was adopted in June 2003⁴

As this makes clear, tax evasion undermines the proper operation of markets and as a consequence we will assess the proposed changes to the STD, announced on 13 November 2008⁵, with regard to their likely effectiveness in reducing tax evasion.

It is important to note that the STD has enjoyed some success in achieving this objective since it became operational on 1 July 2005. In particular, it is important to note the following significant successes that can fairly be attributed to it:

- It is a rare multilateral agreement with the primary intention of tackling tax evasion, which is a notable achievement;
- It has pioneered bulk information exchange between nation states and whilst problems remain its success in doing so should be noted;
- A significant number of third party states and secrecy jurisdictions (tax havens) participate in the STD, which has considerably enhanced its effectiveness;

⁴ http://ec.europa.eu/taxation_customs/taxation/personal_tax/savings_tax/index_en.htm
accessed 21-11-08

⁵ <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1697&format=HTML&aged=0&language=EN&guiLanguage=en> accessed 21-11-08

- Tax has been collected and data has actually been exchanged as a result of the STD: the process it has pioneered has been proven to work;
- It has opened pathways for the current planned extension of the STD. In itself this makes it useful.

We think it important that these achievements be recorded.

Weaknesses in the existing STD

As the main report introducing the proposed STD notes ⁶:

when the EUSD became applicable in 2005, it was apparent that further refinements were advisable to take account of developments in savings products and in investor behaviour.

This is oblique reference to significant avoidance of the requirements of that Directive by some jurisdictions, many ‘economic operators’ (which is the term the STD uses for financial institutions, banks and other persons making payments of interest) and by taxpayers.

Most particularly the requirements of the STD have been avoided by:

- Placing funds on deposit in the name of a limited company, which along with other legal entities are not covered by the existing STD;
- Transferring the sums on deposit into a trust arrangement, which like legal entities are not covered by the existing STD;
- Selecting investments specifically excluded by the existing STD e.g. transferring funds to non-UCITS⁷ funds, a process that was actively assisted by some territories both in and outside the EU and the economic operators that work within those places by proactively creating and promoting these funds for this purpose. Hedge fund investments also fell outside the scope of the existing STD;
- Moving the investment out of cash or interest bearing deposits and into any other form of investment e.g. shares. In addition, a wide range of ‘wrappers’ were created to move assets outside the scope of the STD, such as Certificates on Bonds, Structured Notes and some International Pension Plans and annuities offered in some participating tax havens which did little more than disguise the nature of interest payments.

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[http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_tax/savings_directive_review/COM\(2008\)727_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_tax/savings_directive_review/COM(2008)727_en.pdf) accessed 21-11-08

⁷ Undertakings for Collective Investment in Transferable Securities

- Moving the sums deposited to a non-participating location such as Singapore or Dubai.

The success of the proposed STD needs to be appraised in relation to these abuses of the existing STD.

The proposed STD

This is not the place to summarise all the changes that the proposed STD would make. However, for the sake of setting the comments that follow in context it is worth noting that the press release announcing the proposed revision of the STC said ⁸:

The first review of the Directive has shown that, at present, it is relatively easy for individuals to circumvent the rules by using interposed legal persons or arrangements (like certain foundations or trusts) which are not taxed on their income.

As far as interest payments are made by paying agents (banks, financial institutions, independent professionals, etc.) established in the EU to certain intermediate structures (listed in the compliance list in Annex I of the proposal) established outside the EU, the Commission proposes that paying agents in the EU (who know, under the anti-money laundering provisions that the beneficial owner of the interest payments is an individual resident in the Union) apply the provisions of the Directive (exchange of information or withholding tax) at the time of the payment to the intermediate structure, as if this payment was directly made to the individual.

Concerning payments of interest to certain intermediate structures established within the EU, including some non-charitable trusts and foundations, those structures will be always obliged to act as a “paying agent upon receipt”. This means that the provisions of the Directive (exchange of information or withholding tax) must be applied by these structures upon receipt of any interest payment from any upstream economic operator (bank, financial institution, independent professional), no matter where they are established and regardless of the actual distribution of any sums to the individual beneficial owners. The suggested definition of “paying agent upon receipt” includes all entities and legal arrangements (trust foundations etc) which are not taxed on their income under the general rules for direct taxation in their Member State of residence/establishment (an indicative list of those entities and legal arrangements will form Annex III of the Directive).

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<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1697&format=HTML&aged=0&language=EN&guiLanguage=en> accessed 21-11-08

Extending the scope to income equivalent to interest payments
The Savings Taxation Directive can also be circumvented by using innovative financial vehicles instead of a classical savings account in a bank. Therefore, the Commission proposes extending the scope of the Directive to income from:

- *securities which are equivalent to debt claims (of which the capital is protected and the return on investment is pre-defined),*
- *life insurance contracts whose performance is strictly linked to income from debt claims or equivalent income and have less than 5% risk coverage.*
- *Income from investment funds*

In addition, the Commission proposal seeks to ensure a level playing field between all investment funds or schemes (be it undertakings for collective investment in transferable securities authorised in accordance with the UCITS Directive[1] or not), independently of their legal form. This means that income obtained from those investment funds by individuals resident in the EU will be subject to effective taxation.

This statement provides a useful summary of the objectives of the reform.

Matters to be welcomed

Many aspects of the proposed reforms are to be unambiguously welcomed and in particular:

- The extension of the STD to legal entities (companies, corporations and their like);
- The extension of the STD to arrangements (trusts, settlements, foundations and their like)
- Reform of non-UCITS arrangements so that many more structures will now included within the STD, including some hedge funds;
- The revised obligations on paying agents with regard to tax transparent entities;
- The substantial clarification on the nature and obligations of PAORs;
- The broadened definition of interest and its extension to some products such as life assurance with limited mortality cover.

Issues of concern

The above being noted, there are issues of concern to which we think attention must be drawn, which are listed here and then noted in more detail in the sections that follow. These are:

- The decision not to extend to all legal entities and all forms of capital income;
- The continuation of the withholding tax regime;
- The drafting and scope of Annex 1;
- The drafting and scope of Annex 3;
- The interaction with AML rules;
- Other issues.

Limitation in scope

As the Impact Assessment and its useful summary⁹ make clear, the course of action adopted for reform of the STD was the third of four options considered. Since the first two are less desirable than that adopted they are not considered here, and the Commission is to be applauded for taking a more progressive line than those options suggested were possible.

However, the dismissed option 4 for reform would have extended the STD to payments to all legal persons and to all types of investment income (dividends, capital gains, “out payments” from genuine life insurance contracts and pension schemes, etc). Whilst we are inclined to agree that it may not be pragmatic to undertake this exercise now, it is clear that the STD will evolve and develop over time and we believe that in that context it would be desirable to include a statement of intent to extend the STD to cover these issues in due course if alternative automatic information exchange arrangements relating to these sources of income and gain are not created in the meantime. As such we ask the Commission to consider recording this intent as part of the process of reform of the STD at this time.

Continuation of the withholding tax regime

The STD has included a transitional arrangement that has allowed three jurisdictions within the EU and most of those cooperating with the STD process who are not in membership of the EU to apply a withholding tax on interest payments made to persons who are resident within the EU rather than exchange information with the tax authority in that recipient’s place of residence if the recipient does not wish that exchange of information to take place. Between 70% and 90% of recipients of relevant interest payments to which the STD applies in those jurisdictions offering a withholding option have chosen to allow that withholding

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[http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_tax/savings_directive_review/SEC\(2008\)2767_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_tax/savings_directive_review/SEC(2008)2767_en.pdf) and [http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_tax/savings_directive_review/SEC\(2008\)2768_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_tax/savings_directive_review/SEC(2008)2768_en.pdf) accessed 21-11-08

payment rather than exchange information. This implies that they are evading their taxation liabilities in their country of residence.

It is apparent that tax evasion will not be eliminated until the withholding option without exchange of information is removed from the EU STD.

By definition a transitional arrangement should come to an end and we urge the Commission to commit to a date when this transitional arrangement will cease to be available and full automatic information exchange will be required.

Annex 3

For convenience we consider Annex 3 and its drafting before Annex 1.

In principle we support the proposals in Annex 3. We believe it appropriate that an entity or legal arrangement which is not taxed on its income or on the part of its income arising to its non-resident participants, including on any interest payment, under the general rules for direct taxation applicable in the Member State in which the entity or legal arrangement has its place of effective management, shall be considered a paying agent upon receipt of an interest payment or upon securing of such payment.

We do however note that Annex 3 does not appear to fulfil this objective.

First, we note that Gibraltar is not included in either Annex 1 or Annex 3. We suspect it should be included in Annex 3 because of its special relationship with the United Kingdom for the purposes of the STD, but its omission from either is a serious oversight and should be corrected.

We approve of the notion inherent in Annex 3 that the list refers to trusts and similar legal arrangements whose place of effective management of their movable assets is in these countries irrespective of the laws under which these trusts and similar legal arrangements have been set up. There do, however, appear to be surprising omissions from the list of jurisdictions in which it is presumed that this can occur in a tax transparent fashion. We believe that trusts and other similar legal arrangements should be listed in Annex 3 for all EU countries. As a result would suggest that their individual specification is not required.

The countries for which a reference to trusts is omitted at present are Germany, Malta, the United Kingdom and Ireland. We think these are omissions and oversight for these reasons:

- Whilst Germany has no trust law its residents are allowed to administer foreign law trusts: therefore, Germany should be listed with regard to trust arrangements;

- The United Kingdom, Malta and Ireland all have extensive trust industries and very large numbers of trusts, none of which have to be registered with a taxation authority to have legal effect. As such we think the omission with regard to these territories particularly serious precisely because those who wish to evade tax might now create trust structures in these locations which are then not registered with the relevant taxation authority but which could receive gross interest without being deemed a PAOR under the terms of the proposed STD. To prevent this possibility arising we strongly recommend that the inclusion of trusts and similar arrangements on the listing of each member state in Annex 3.

We also note that foundations are not specifically referred to in Annex 3, but we are the opinion that foundations could be managed within any EU member state. We think that foundations are sufficiently dissimilar from trusts to not fall within the description of 'other similar legal arrangements' and would therefore suggest that the phrase 'Trusts or other similar legal arrangements' be amended and be specified as 'Trusts, Foundations and other similar legal arrangements' within this annex so that doubt is avoided.

We note that the Annex 3 listing for Ireland appears to omit a number of structures which might be tax transparent, or are not taxed upon receipt of interest income. These might include general partnerships, limited partnerships, investment limited partnerships and non-resident limited liability companies (which remain in existence in Ireland and are not subject to its taxation as a result) and Irish Common Contractual Funds¹⁰. Their equivalents (if they exist) in the UK are listed and as such the exclusion of these entities in Ireland is surprising. We do therefore suggest that a more thorough review of the entities listed in Annex 3 is required and that it is not at present complete. We have not been able to undertake a review of this data for all EU jurisdictions in the time available to prepare this report.

We are however concerned to note that in general Annex 3 does in fact only relate to trusts and similar legal arrangements despite the fact that Article 4 (2) which will give its legal status quite specifically refers to entities and legal arrangements which are not taxed on their income or part of their income arising to non-resident participants. There appears to be a serious error or omission in Annex 3 as a consequence because there are a substantial number of entities, including those noted above with regard to Ireland, which are not taxed on their income or on that part of their income arising to non-resident participants and as such a major re-drafting of Annex 3 to include these corporate structures would appear to be necessary.

¹⁰ See <http://www.deloitte.com/dt/alert/0,1002,cid%253D206393,00.html> accessed 21-11-08

Annex 1

We believe that there are a number of significant problems in the current drafting of Annex 1 to the report.

We confirm that we do think the underlying logic of treating entities listed in Annex 1 as being tax transparent, with information disclosure or tax deduction at source being required as a consequence is appropriate. We do, however, think the list of jurisdictions to which Annex 1 refers is incomplete whilst the listing of entities considered tax transparent within each jurisdiction appears substantially incomplete, and the process for their listing appears inappropriate. We refer to these issues in turning the following paragraphs.

Based upon our research we believe that the following additional jurisdictions should be referred to in Annex 1:

- Alderney (in Part 2), which can in some circumstances be considered a different jurisdiction from Guernsey;
- Anjouan, which is now actively promoting its financial services industry;
- Canada, because of its non-resident trust laws;
- Dubai, which is widely known as a financial services centre;
- Ghana, which is now promoting itself as a new tax haven;
- Grenada, which is widely recognised as a tax haven, for example by the OECD in 2000 and in the draft US legislation for the Stop Tax Haven Abuse Act,
- Liberia, not least for activities related to its shipping registry;
- Macedonia, which is now promoting itself as a new tax haven;
- Montenegro, which is now promoting itself as a new tax haven;
- New Zealand because of its trust laws;
- Ras Al Khaimah, UAE, which is now promoting itself as a new tax haven¹¹;
- Sao Tome e Principe which has promoted some tax haven style activities;
- Sark (in Part 2), for the same reasons as Alderney, noted above;
- Somalia, which some have sought to promote as a new tax haven;
- USA, see below.

The omission of the USA is difficult to justify. It is widely known, and it is recognised in draft legislation before the US Senate, that a great many tax transparent corporations are created in the USA about which the US government has no information as to beneficial ownership. Many of these are in practice tax neutral with the income of the corporation being taxed upon its membership if they can be identified. In the circumstances it appears important that the USA, or certain designated states of the USA such as Delaware, Nevada and Wyoming where incorporation of such entities is commonplace, be added to Annex 1. If this is not

¹¹ http://www.gulfnews.com/uae/rak/sub_story/10068322.html accessed 24-11-08

done then we are fearful that the reaction of those states listed will be similar to that which gave rise to significant, and to some degree successful opposition to the listing of states promoting harmful tax competition produced by the OECD in 2000. This would be unfortunate and should be avoided by making reference to the necessary states in Annex 1.

The omission of necessary jurisdictions from Annex 1 is important. As important is the omission of significant numbers of relevant tax transparent entities that are available in many of the locations that listed. The significance of this is apparent from reading the Technical Questions note¹² issued by the Commission to support the proposed changes to the STD. In that note it is said that:

Question: What if interest payments are made by financial institutions established within the EU to intermediate structures established outside the 42 jurisdictions participating in the Savings Tax network for the benefit of EU resident individuals?

Answer: Two situations can arise. Either the intermediate structure is in listed in Annex I of the Directive or not. If it is not included in the list, the provisions of the Directive will not apply.

It is apparent as a result of the answer given that the Annex 1 listing is meant to be authoritative and binding in determining whether the intermediate structure is outside the savings tax network, or not. The Commission have admittedly said that they would expect there to be a relatively simple mechanism for adding and delisting entities in both parts one and two of Annex 1, but this does not seem to justify the publication of a substantially incomplete list at this time.

Taking just a limited range of jurisdictions into account, and considering as a result only Guernsey, Jersey and the Isle of Man (in Part 2 of the Annex) it is very apparent that the lists are incomplete and inconsistent. For example, something called a 'zero tax company' is referred to in Guernsey but there is no equivalent mention in Jersey or the Isle of Man. In fact, all companies in Guernsey are now subject to zero tax, a situation replicated in both Jersey and the Isle of Man. However, there is no such thing as a zero tax company in any such location, meaning that the definition is wrong for Guernsey, let alone Jersey and the Isle of Man. A full list for these places might include limited companies, exempt companies (which still exist), international business corporations (which likewise still exist) protected cell companies, incorporated cell companies, limited partnerships, international limited partnerships (Isle of Man only) and general partnerships which can be treated as non-taxable in respect of non-resident owners, and all this in addition to trusts in a variety of forms together with

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http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_tax/savings_directive_review/technical-questions.pdf accessed 21-11-08

foundations in the case of Jersey, who is now introducing legislation for these structures.

What this makes clear is that the listing in Annex 1 is dangerously incomplete as a list of structures to be recognised as tax transparent, especially when taking into account the status that it is given in the technical questions briefing. If the list is published in the final STD as drafted at present substantial opportunities to tax evasion will continue to exist and will be exploited. This possibility must be avoided.

There appear to be two potential solutions to this problem. The first is to commission a detailed review of all those jurisdictions and structures that should be included in Annex 1. Alternatively or additionally, a principles based approach to the listing could be adopted so that a generic listing of those entities likely to be considered as tax transparent is published and applied to all jurisdictions in the first instance with an onus of proof resting on a jurisdiction if they wish to have an entity of the type named excluded from the list for their jurisdiction.

If this second alternative were adopted, and we strongly recommend that it is, then there should be in existence a mechanism for adding newly identified generic entities to the listing, with potential applicability to all jurisdictions. There must also be the facility to add jurisdictions to the list if any is discovered creating tax neutral structures of any of the types noted. In combination this will prevent the creation of a process, at which many jurisdictions are adept, of developing new forms of structure to facilitate tax abuse.

We would propose that the following types of entity should be listed as being automatically deemed tax transparent for STD purposes in every jurisdiction referred to in Annex 1, without differentiation between parts 1 and 2 of that annex:

- Limited liability company, however otherwise described and however limited, whether it be by shares, guarantee or some other mechanism;
- Limited liability corporations, however otherwise described and however limited, whether it be by shares, guarantee or some other mechanism;
- International companies or corporations;
- International business companies or corporations;
- Exempt companies or corporations;
- Protected cell companies or corporations, however otherwise described;
- Incorporated cell companies or corporations, however otherwise described;
- International banks, including corporations of similar name;
- Offshore banks, including corporations of similar name;
- Insurance companies or corporations, however described;
- Reinsurance companies or corporations, however described;
- Co-operatives, however otherwise described;
- Credit unions, however otherwise described;

- Partnerships of all forms, however described, including (without limitation) general partnerships, limited partnerships, limited liability partnerships, international partnerships and international business partnerships;
- Joint ventures, however otherwise described;
- Trusts of all forms, however otherwise described;
- Settlements of all forms, however otherwise described;
- Foundations of all forms, however otherwise described;
- Estates of all forms or the estates of deceased persons, however otherwise described;
- Funds of all forms, however, otherwise described;
- Branches of any of the entities and arrangements listed here, however described;
- Representative offices of all sorts;
- Permanent establishments of all sorts.

This list is not meant to be authoritative: it is a first suggestion. We stress that in each and every case we are suggesting that a jurisdiction should have the right to make application to have a particular structure removed from the list for its jurisdiction, but only on submission of evidence that it cannot be relevant within its domain.

We believe that unless this approach is adopted there will be substantial risk that some relevant structures will be omitted from Annex 1 with the result that increased opportunity for tax avoidance or tax evasion will arise. This is the sole motivation for our recommendation. We do not believe this recommendation will place an onerous burden of administration upon the jurisdictions listed and will, in contrast, provide them with a clear incentive to reduce as far as is possible the number of entities to which the STD will refer within their domain, so giving them the opportunity to indicate their compliance with internationally accepted standards, a process which we believe will provide them with a valuable incentive to reform the structure of their financial services sectors.

We are aware that the listing we have produced might appear cumbersome. This is, however, necessary because jurisdictions have proved themselves adept at marginal innovation using mildly differing names to produce as a consequence what appear to be new entities. The style of drafting used is intended to discourage this tendency.

Dependence upon Anti-Money Laundering Records

We have a further issue of concern to go to the process proposed with regard to structures listed in Annex 1.

We note that the STD proposes:

to ask paying agents subject to the anti-money laundering (AML) obligations to use the information already available to them under these obligations, insofar as it relates to the actual beneficial owner(s) of a payment made to some legal persons or arrangements ('look-through' approach). The EU paying agents should only focus on legal persons and arrangements established in selected jurisdictions outside the EU, where appropriate taxation of interest income paid to these legal persons or arrangements is not ensured. When the beneficial owner identified for AML purposes is an individual resident in another MS of the EU, the payment should be treated by the EU paying agent as made directly to this beneficial owner.

In principle this appears reasonable, but it would appear that a significant development in AML 'Know Your Client' procedures authorised by the 3rd EU Money Laundering Directive and the equivalent FATF rules has been ignored. Under these arrangements a risk based approach to AML KYC rules is adopted. This was neatly summarised in a Jersey Financial Services Commission paper which said of the new requirements¹³:

A risk-based approach to customer due diligence is set out, that permits reduced or simplified measures in the case of "lower" risk relationships, and requires enhanced customer due diligence in the case of "higher" risk relationships.

Much more emphasis is placed on customer due diligence measures other than identification and verification of identity, and, in particular, on ongoing monitoring of unusual, complex, and "higher" risk activity and transactions.

More "customer friendly" ways of verifying the identity of applicants for business or customers, including scope for greater reliance on a single document to verify identity in "lower" risk circumstances. In the case of an applicant for business that is an individual and is assessed as presenting "lower risk", identity will consist of just name, address, and date of birth, and just name and date of birth need be verified. This means that it will be possible to verify the identity of such applicants using just one document, e.g. a passport.

This approach is confirmed in the following section of the UK's new Money Laundering Regulations 2007, which says¹⁴:

Meaning of customer due diligence measures
5. "Customer due diligence measures" means—

¹³ http://www.jerseyfsc.org/pdf/hbk_consultation%20paper_04.pdf accessed 24-11-08

¹⁴ http://www.opsi.gov.uk/si/si2007/uksi_20072157_en_3#pt2-l1q5 accessed 24-11-08

- (a) identifying the customer and verifying the customer's identity on the basis of documents, data or information obtained from a reliable and independent source;*
- (b) identifying, where there is a beneficial owner who is not the customer, the beneficial owner and taking adequate measures, on a risk-sensitive basis, to verify his identity so that the relevant person is satisfied that he knows who the beneficial owner is, including, in the case of a legal person, trust or similar legal arrangement, measures to understand the ownership and control structure of the person, trust or arrangement; and*
- (c) obtaining information on the purpose and intended nature of the business relationship.*

It is obvious from this regulation that there is now no requirement that a paying agent regulated for AML purposes prove the address of their customer, a fact made equally clear by the observation in Jersey. They need only prove their identity. Of course, very often this will include data on a person's residential address, but it cannot be assumed that this will be the case in low risk situations. Since deposit paying bank accounts of the type most commonly targeted by the STD will, even when held by trusts or legal entities, almost certainly be considered low risk investments for AML purposes there is a very high chance that STD regulated paying agents will not know the address of the beneficial owner of the structures listed in Annex 1 to the proposed STD. In that case the 'look through' arrangements proposed will not work because the evidence that the beneficial owner is resident in the EU may not be available, and it is possible that some paying agents will wilfully exploit this fact.

We believe that urgent action is required to ensure that this loophole is not exploited, a possibility that we think the current drafting of the proposed Article 3 (2) might permit. In particular we would propose that all paying agents be required to assume the following unless they hold evidence to the contrary:

- That their customer is resident in their country of citizenship if their passport has been used to prove their identity;
- That their customer is resident in the country issuing them with an identity card if that has been used for the purpose of proving their identity;
- That their customer is resident in the country issuing them with a driving licence if that has been used for the purpose of proving their identity.

There is, however, risk inherent in each of these processes and we therefore strongly recommend that the STD be amended and that each EU member state be required to issue any person who is tax resident within their domain with a certificate of tax residence, specifying the address to which it has been sent, on demand and that paying agents be required to secure such certificates from their customers annually as evidence of their tax residence for the purposes of correctly applying the provisions of the proposed STD. Agencies then responsible for

monitoring AML compliance should be encouraged to review paying agent compliance with this requirement.

Unless such arrangements are adopted we are very concerned that considerable tax evasion may be possible as AML requirements might be exploited by those wishing to inappropriately record their place of taxation residence.

Other issues

A range of other issues do require consideration. For example, there are many pension ‘wrappers’ now available in locations such as Guernsey which barely disguise the receipt of an income stream derived from interest. The treatment of such arrangements needs careful consideration, as do annuities which are presented in a similar way.

The proposed arrangements would regard a life assurance also pose problems: the proposed requirement that no more than 5% of the invested fund be dedicated to life assurance related risk provides clear opportunity for avoidance activity since the suggested limit is very low and allows 95% of the product to be solely investment related. We suggest that a much requirement with not less than 20% of the funds being dedicated to life assurance related risks would be substantially more appropriate and would significantly reduce the opportunities for tax avoidance using such mechanisms.

Finally, interest swap arrangements are not adequately dealt with in the proposed STD and it would seem that more work is required in this area or abuse is likely.

Conclusion

We have identified issues and concerns with regard to the proposed STD. We do, however, wish to make clear our support for the extension of the STD and the broad approach that the Commission has adopted. We wish them well in their work and offer our support if it might facilitate progress.