# REPORT

# 2013

# WORKABLE SOLUTIONS

FOR

# EFFICIENT AND SIMPLIFIED FISCAL COMPLIANCE PROCEDURES RELATED TO POST-TRADING WITHIN THE EU

## THE TAX BARRIERS BUSINESS ADVISORY GROUP – T-BAG

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## Executive Summary

### *Current Problems*

Member States currently adopt a variety of different approaches to the issue of withholding tax, which has been described in previous reports and the work of Alberto Giovannini. These problems can be broadly categorised as follows:

1. Concerns over the legal basis under which cross border tax simplification could be implemented
2. Lack of adequate or consistent interpretive guidance from Member States
3. Lack of a consistent tax relief model between Member States
4. A plethora of procedures, forms and information requirements from Member States
5. Lack of a mandate for the use of automation and standards.

The T-BAG Group has reviewed these issues in context to the different withholding tax systems currently operated by Member States in detail and its recommendations for specific issues to facilitate Member States adopting a simplified approach.

As part of its review, and in context to the FISCO recommendations, the T-BAG Group also reviewed the remedial tax reclaim processes of Member States and makes recommendations here for the provision of an E.U. wide standardised tax reclaim which would lend itself to the transition by Member States from paper based reclaim processing, to electronic and thus contribute to achieving the removal of some of the tax barriers laid out by Professor Alberto Giovannini.

### *International Context*

A comparative analysis to the US system (US Revenue Code Chapters 3 and 4) allows the T-BAG Group to provide suggestions on those aspects of the US system which would work effectively in a European context, notwithstanding that at least one European Member State has already implemented a similar, albeit simplified system (i.e. Ireland). This applies particularly to the procedural aspects of contracts, documentation, withholding, information reporting and audits.

A comparative analysis to the work of the O.E.C.D allows the T-BAG Group to recommend several areas where there are common elements of an Authorised Intermediary system on which significant granular work has already been completed e.g. self certifications of residency, standardised messaging and from which, both business and Member States could benefit in terms of both reduced development and implementation costs in a European context.

### *Recent Changes*

In normal circumstances Member States and the T-BAG Group itself would have had ample time to weigh considerations and recommendations on its mandate. However, in the last two years and more recently in the last six months, the rate of change in the international environment both inside the EU and outside it, has increased rapidly. Some of these changes are outside the direct mandate of the T-BAG Group. Others, albeit in principle within the mandate, have only recently become substantive and the Group has not had sufficient time to analyse them in detail nor make recommendations. Notwithstanding this, the T-BAG Group

urges the Commission and Member States to take cognisance of this amplified rate of change which, we believe, increases the need for an integrated approach to short and long term planning. Some of the issues which are not analysed in detail in this report but which should be included in further work are:

1. Effects of the widespread implementation of a Financial Transaction Tax (FTT).
2. Use of Legal Entity Identifiers (LEIs) as an additional beneficial owner identification tool;
3. Effects of the implementation of the Target 2 Securities (T2S) securities settlement platform.

Initial commentary on these issues is included in Appendix 6.

For the avoidance of doubt the Group recommends an explicit support for many of the elements of the TRACE Implementation Protocol (IP) for short term solutions since many aspects of the IP (i) are congruous to the Group's recommendations and (ii) already have substantive implementation detail associated with them from which Member States can benefit.

***Summary of the Proposed Solution Framework***

The solution recommended has the following major characteristics. If the recommendations are approved by Member States, further work will produce the lower level detail for a workable phased implementation.

(1) Member States agree a common standardised "Authorised Intermediary" Agreement ("AIA") which may be entered into between a financial intermediary and a Member State.

(2) AI Agreements would provide rules for the conducts of (i) documentation of beneficial owners, (ii) application of relief at source on payments, (iii) withholding, (iv) information reporting and (v) control and oversight;

(3) Member States agree a common form and distribution mechanism (e.g. web site) for Guidance on the application of treaty benefits to different types of beneficial owner on which an AI may rely, subject to the understanding that such guidance does not over-rule a Member State's ability to question any specific case for a claim of treaty entitlement. It is envisaged that existing mechanisms for clarification of individual cases would still be available;

(4) The identification of beneficial owners to be permitted by AIs through the mechanism of (i) Taxpayer Identification Numbers (TINs) issued by the beneficial owner's home State, (ii) application of the KYC rules of the AI's home State, to the extent that the source State accepts the degree to which, in its view, KYC rules establish beneficial ownership and (iii) agreement by Member States to the development and use of a common and electronically transmissible self-certification of residency ("Investor Self-Declaration" or "ISD"). To the extent possible, the system should permit the use of Powers of Attorney ("PoA") to allow AIs and authorised third parties to facilitate any additionally required documentation;

(5) Provided the documentation and identification rules are met, AIs would be permitted to make (or instruct) payments to eligible beneficial owners net of the appropriate treaty rate of withholding tax on pay date.

(6) Liability for under-withholding and/or incorrect documentation of beneficial owners should lie (i) with the beneficial owner (for incorrect or fraudulent representations), (ii) the AI for processing errors and (iii) the Source Member State for technical issues related to treaty eligibility, the latter being minimised through the clear Guidance proposal.

(7) AIs servicing beneficial owners directly would provide annual information reports (i) to the source State at beneficial owner level of disclosure and (ii) upstream at pooled level (by withholding rate applied) to other AIs in the payment chain. Such reports to be electronic and to a format standardised between Member States e.g. XML;

(8) Where a source country receives information reports from an AI and wishes to query the eligibility of any beneficial owner, Exchange of Information rules would be applied to permit the source country to apply directly to the home country using the TIN of the beneficial owner;

(9) Under the terms of an AI agreement, AIs would be subject to a choice of internal review, certified by a responsible officer and subject to appropriate penalties, or external oversight by an approved independent third party by means of an Agreed Upon Procedure" ("AUP") whose report would be available to the Source Member State. Governments would retain the right to undertake spot checks in both cases.

(10) For those beneficial owners who were unable to meet the relevant documentation standards prior to pay date, but where they can still prove eligibility under a treaty, Member States agree to develop a standardised, machine readable tax reclaim form capable of being delivered electronically.

# 1. Introduction[1]

## 1.1 Aim of the T-BAG Group

The aim of the Tax Barriers Business Advisory Group is to consider the follow-up of the Commission Recommendation on simplified Withholding Tax procedures from a business perspective and to identify any remaining fiscal barrier affecting the post-trading environment.

## 1.2 Structure of the Report

The Report is structured in four parts and assumes an understanding of the prior work and context of the Giovannini committee, subsequent Reports of FISCO and the Commission Recommendation on Simplified Withholding Tax Relief Procedures.

- **Part 1** describes the current situation in Member States and the legal basis under which Member States may choose to adopt the committee's recommendations. This part also provides an example of harmonisation in the field of financial law.
- **Part 2** describes parallel initiatives currently under way. A comparison is provided between the current EU work and related work at the OECD. This Part also describes the current situation in the US, including the US regulations (Chapter 3 - QI and Chapter 4 – FATCA).
- **Part 3** provides a description of how, in practice, the current tax relief at source and reclaim procedures could be improved to work more efficiently. This Part also provides guidance on how to improve the exchange of information, liabilities and the use of Tax Identification Numbers (TIN:s). The aim of the guidance is to reduce the current risks and compliance costs for investors, intermediaries, tax authorities and Member States.
- **Part 4** provides a Summary and Conclusion to the Report.

**Appendices** are provided where background or supporting material may be useful to understand the context of recommendations made in the body of the report.

A **Glossary of terms** is presented in order to explain commonly used and technical abbreviations and/or acronyms.

## 1.3 Mandate

According to its mandate the T-BAG Group should:

1. Examine and update the current state of withholding tax relief and/or refund procedures in EU Member States with respect to double tax conventions and domestic law.

2. Suggest workable solutions to implement the principles outlined in the Commission Recommendation on Withholding Tax Relief Procedures (COM (2009) 7924 final), that might be acceptable to Member States' tax authorities.

[1] This Introduction has been prepared by the Secretariat of the T-BAG Group.

This task should have regard to parallel OECD work in this area and would involve a two-step approach as follows:

a. short-term measures aimed at improving withholding tax relief procedures (e.g. widespread use of Taxpayer Identification Numbers; standardised claim forms; standardised residence certificate having an harmonised validity period; use of electronic systems; etc.); and
b. long-term, more ambitious and comprehensive solutions based on a simplified relief at source system.

3. Identify and suggest changes to address any possible other (remaining) tax barriers affecting the post-trading environment.

The present document has been produced by the T-BAG Group in line with its mandate. It is important to underline that the solutions proposed in this report relate to fiscal compliance procedures and are not aimed at any tax (rate) harmonisation. The aim of the proposed solutions is solely to remove fiscal compliance barriers related to EU clearing and settlement and to make local fiscal procedures work more efficiently. The aim is also to propose improved procedures adapted to the way financial markets operate today. Member States and the tax authorities will probably substantially gain by more efficient fiscal compliance procedures related to post-trading. And so will the industry, the investors, the tax payers and the internal market as a whole.

The T-BAG Group has also considered some key documents and reports already provided in the fiscal compliance area related to post-trading, such as the Giovannini-, FISCO- and Monti Reports, the Commission Recommendation on Simplified Withholding Tax Procedures including its Economic Case and the relevant conclusions from the ECOFIN.

The T-BAG Group consists of a number of high-calibre experts from private bodies and the academic community. To facilitate the work of the Group, the Commission provided a Secretariat made up of a Chairperson and a Secretary from the Commission's Directorate General for the Internal Market and Services. Two officials from the Commission's Directorate General for Taxation and the Customs Union participated as Observers. The Organisation for Economic Co-operation and Development (OECD) is represented as Observer. Details of the members of the group are provided in Appendix 1.

## 1.5 Prior Work

### 1.5.1 The Giovannini Reports

The Giovannini Group of financial market experts, that advised the European Commission on financial market issues, published two reports in 2001 and 2003. They asserted that "inefficiencies in clearing and settlement represent the most primitive and thus the most important barrier to integrated financial markets in Europe." Furthermore, the removal of these inefficiencies was "a necessary condition for the development of a large and efficient financial structure in Europe".

The first Giovannini Report identified 15 key barriers to an efficient pan-European clearing and settlement system for the EU. Two of these barriers (11 and 12) relate to

fiscal compliance procedures. Barrier 11 relates to domestic withholding tax regulations, i.e. that foreign intermediaries cannot sufficiently offer withholding tax relief at source or only under the condition that they have a fiscal agent. Barrier 12 deals with national provisions requiring that taxes on securities transactions be collected via local systems.

The second Giovannini Report of April 2003 called for the following:

1. *all financial intermediaries established within the EU should be allowed to offer withholding agent services in all of the Member States so as to ensure a level playing-field between local and foreign intermediaries (Barrier 11); and*
2. *any provisions requiring that taxes on securities transactions are collected via local systems should be removed to ensure a level playing-field between domestic and foreign investors (Barrier 12).*

The Giovannini reports highlighted that national governments should co-operate closely with the private sector in removing these barriers.

### 1.5.2 Summary of the FISCO Reports

The EU Clearing and Settlement Fiscal Compliance Experts' Group ('FISCO') that was created in March 2005 following the Communication "Clearing and Settlement in the European Union – The way forward"[2] had as one of its key objectives the resolution of Giovannini Barriers 11 and 12.

The FISCO Group published two reports –The FISCO Fact Finding Study 2006[3] and the FISCO Second Report on Solutions to fiscal compliance barriers related to post-trading within the EU 2007[4]. The two reports described as a serious problem the fact that withholding tax collection and relief procedures vary considerably between Member States and that different procedures often apply even to different classes of securities within the same Member State. Many Member States restrict withholding responsibilities to entities established within their own jurisdiction. As a consequence, foreign intermediaries are often disadvantaged in their capacity to offer relief at source from withholding tax due to the significant extra cost of using a local agent or local representative in the discharge of their withholding obligations. The reports also pointed out that Member States' current relief procedures do not take sufficient account of the multi-tiered holding environment and often put tax collection responsibilities on an entity that is not connected to the beneficial owner/final investor. These procedures therefore assume that the market will organise itself to transfer information and (paper form) documentation on the beneficial owner up through the chain of intermediaries. In reality, however, this is costly and inefficient and may also create confidentiality and data-privacy issues. The FISCO Group concluded that the present fiscal compliance procedures hinder the functioning of capital markets and increase the cost of cross-border settlement. It said that the

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[2] COM(2004) 312 final

[3] http://ec.europa.eu/internal_market/financial-markets/docs/compliance/ff_study_en.pdf

[4] http://ec.europa.eu/internal_market/financial-markets/docs/compliance/report_en.pdf

complexity and administrative costs resulting from the present procedures may lead investors to forego the relief to which they are entitled and may, for the same reason, discourage cross-border investment.

The FISCO Group proposed solutions aimed at improved, standardised, simplified and modernised withholding tax relief procedures that would be adapted to the way financial markets operate today. The present procedures are both costly and inefficient. The FISCO Group was of the opinion that:

- *At-source relief procedures* are the best method to improve the present situation because of the optimized cash flow they offer to investors;

- In order to make relief procedures simpler, paper-form certificate of residence should be replaced by alternative means to prove the investors' entitlement to tax relief, such as *self-certification and know-your-customer (KYC) rules.* Furthermore intermediaries should be allowed to make use of modern technology to pass on investors' information to the withholding agents *in electronic format*.

- Many of the existing problems could be solved by *shifting withholding responsibilities* to intermediaries i.e. by allowing all intermediaries in the custody chain either to assume full withholding responsibilities or to take responsibility for granting withholding tax relief by passing on pooled withholding tax rate information to the upstream intermediary. Avoiding the need for intermediaries to pass detailed information on beneficiaries up the chain would overcome data protection and client confidentiality concerns.

- Even though relief at source is the preferred relief method, there is a clear need also for *efficient refund procedures*. A supplementary standard and quick refund procedure should be implemented within the Member States by using similar formats for applications, by centralising refund procedures in each Member State to one tax authority or tax office only and by introducing a time-limit for making the refunds. The reclaim process should also be capable of electronic adaptation in order to optimise efficiency.

### 1.5.3 Commission Recommendation on Simplified Withholding Tax Relief Procedures

On October 2009, the European Commission adopted the Recommendation on Withholding Tax Relief Procedures, COM (2009) 7924 final.

The aim of the Recommendation is to make it easier for an investor that is resident in one EU Member State to claim withholding tax relief on dividends received from another Member State. The Recommendation also encourages greater acceptance by Member States of electronic, rather than paper, information and suggests measures to eliminate the tax barriers that financial institutions face in their securities investment activities while at the same time protecting tax revenues against errors or fraud.

The Recommendation also suggests measures to eliminate tax barriers for the securities investment activities of financial institutions. This is important because a study carried out by the Commission services shows that, at present, the costs related to current reclaim procedures are estimated at a value of €1.09 billion annually, whereas the amount of foregone tax relief is estimated at €5.47 billion annually.

The Recommendation provides guidance on how to ensure that procedures to verify entitlement to tax relief do not hinder the functioning of the Single Market. In particular, the Recommendation encourages Member States to apply at source, rather than by refund, any withholding tax relief applicable to securities income under double taxation treaties or domestic law. Where tax relief at source is not feasible, the Recommendation suggests that quick and standardised refund procedures should be in place, and lists possible elements of such refund procedures. It also encourages Member States to accept alternative proof of investors' entitlement to tax relief besides certificates of residence. The Recommendation further suggests how Member States can involve financial intermediaries in making claims on behalf of investors and, in particular, how the procedures could operate where there is a chain of financial intermediaries, in different Member States, between the issuer of the securities and a beneficiary. It also invites Member States to make greater use of existing channels for exchange of information between them and the exploration of new channels.

### 1.5.4 The Internal Market

The tax dimension was highlighted as a key issue of the Single Market in Professor Mario Monti’s Report to President Barroso on "a new strategy for the single market" 2010. The Monti Report considered it important to cut the tax-related administrative burdens and compliance costs for business and citizens. Consequently, the Monti Report identified further work urgent on the elimination of tax barriers, including updating the rules on cross-border relief.

### 1.5.5 ECOFIN

The Economic and Finance Ministers of Member States Meeting in Council (ECOFIN) has many times stressed that post-trading of securities transactions is a key area for financial integration in the EU and that the removal of fiscal compliance barriers is urgently needed.

The Economic and Finance Ministers of Member States meeting in Council (ECOFIN):

- In November 2006, stressed that post-trading of securities transactions is a key area for financial integration in the EU and that the removal of fiscal compliance barriers is urgently needed;

- In October 2007, restated that concrete actions should be proposed promptly by the Commission on the basis of the work of the advisory groups; and

- In June 2008, noted the Commission's intention to adopt a Recommendation on withholding tax procedures by the first part of 2009 and to take into account the need to both simplify and improve tax efficiency.

- In June 2011, invited the Commission and the Finance Ministers of the participating Member States to report back on progress made on tax policy issues, notably to ensure the exchanges of best practices.

The actual financial crisis illustrates the importance of efficient, safe and sound post-trade within the EU. The current situation highlights the importance for the Member

States to be competitive as issuers of different debt instruments, in order to obtain sufficient resources to manage the crisis. Considering the present lack of liquidity and financing need, both for Member States and industry, the case for simplification in capital markets is stronger than ever.

### 1.5.6 Follow-up of the Commission Recommendation

When creating the Commission Recommendation on Simplified Withholding Tax Procedures, Member States were regularly updated, by presentations and discussions, at meetings of the Working Party No IV ("WP IV") on Direct Taxation –were all Member States are represented - of the European Commission's Taxation and Customs Union Directorate General and of the Commission's European Securities Committee (ESC).

After the adoption, Member States has actively discussed the follow-up of the Commission Recommendation at meetings of WP IV. It has during these meetings been highlighted among Member States that the Recommendation is an important step forward, but several issues need to be analysed further, such as the liability of foreign financial intermediaries and the need to improve exchange of information. Member States have reconfirmed that they are positive that the Commission goes ahead on this urgent dossier and explores these topics further.

The Commission has also performed successful missions to some Member States, including Finland and Germany, to study the practical transposition of the Recommendation.

*DISCLAIMER*
*The Directorate General for the Internal Market and Services in the European Commission chaired and acted as Secretariat for the Group. Officials from the Taxation and Customs Directorate General participated as observers. This Report should not be construed as in any way reflecting the official position of the European Commission and its services. Neither the Commission nor any person acting on behalf of the Commission is responsible for the use which might be made of the information contained herein*.

# Part 1 - The Current State of Play

This part of the T-BAG Report is intended to establish the basis on which our recommendations are made. This Part in conjunction with prior reports, notably FISCO, have researched and documented both the legal and practical context in which any recommendations made would need to be workable.

## 2. Legal Barriers to simplification in Member States

Appendix 3 provides an analysis of the current legal barriers to simplification and expands on the comments below with reference to some of the ways in which Member States could approach and resolve these issues.

In a legal context, the EU has several mechanisms currently available which could be used as the basis for simplification. These include:

- Statutory harmonisation
- Enhanced Cooperation
- ECJ Case law
- EU Directive

Statutory harmonisation is both insufficient, of itself and has practical difficulties associated with it that mean it is unlikely to be the sole method by which the recommendations of this report can be implemented. Not least of these are the disparities between the EC Mutual Assistance Directive and the EC Recovery Directive. These include levels of proof required to be able to apply the Directive, lack of obligations in the Directive and practical difficulties in identifying taxpayers in pooled investment vehicles.

There are alternatives to statutory harmonisation. Enhanced cooperation between Competent Authorities is referenced in the Markets in Financial Instruments Directive (“MiFID") in terms of strengthening duties of assistance. Level 4 legislation is also referenced as a possible legal approach. In addition, in many cases national laws represent an impediment to simplification because they are not consistent across borders.

In recent years there has also been an observable increase in the number of cases brought to the European Court of Justice (“ECJ”) which highlights another opportunity for simplification, at least in the case of providing greater clarity of interpretation of treaties. The practice of ECJ is based on several principles including those of (i) effectiveness, (ii) proportionality, (iii) equivalence and (iv) interpretation of national law with Community law. These are all discussed in detail in Appendix 3. The net effect of these issues is to formulate common practices supported by the case law in such a way as to effectively create a simplification through clarification. However, the use of ECJ as a strategy to achieve simplification is costly, long-winded and confrontational.

In its broadest sense, a bottom up strategy of simplification whether through enforcement via case law or via statutory harmonisation or via existing alternatives, will face almost insurmountable obstacles of complexity. Adoption of a *[Harmonisation]* Directive also has advantages and disadvantages. In the current framework, Directives take extended periods of time to implement due the need to not only define common simplification policies and procedures (which is common for all

solutions) but also protracted negotiations between Member States which generally results in a 'lowest common denominator' solution that may not be the most effective for the market or for investors.

### *2.1 Current State of Withholding Tax Relief Procedures in Member States*

Tax relief procedures generally fall into one of three categories in Member States:

1. Tax relief at source, in which treaty entitlements or exemptions are applied on the pay date based on documentation available on the record date (in the case of equities) and an end of day holding (in the case of fixed income instruments);
2. Quick refund, in which an intermediary nets off an amount from tax withheld at statutory rate on pay date based on subsequent evidence of treaty entitlement prior to the date on which the intermediary is required to submit tax to its domestic tax authority; and
3. Long Form reclaims in which entitlements are claimed back using prediominantly manual methods post pay date and within a statute of limitations period.

It is a common commentary in the investor community that its one thing to *have* an entitlement and quite another and more difficult thing to *receive* an entitlement. This serves as an apposite commentary of the current state of play in the market today.

Some Member States allow permutations of the above methods. Relief at source is generrally only offerred by domestic financial institutions in each Member State which, in addition to applying domestic law, often have their own individual documentary requirements, deadlines and procedures. In addition, relief is often restricted to certain types of account and types of beneficial owner dependent on the individual advice received within the institution and their own business commercial restrictions. Long Form Reclaims are generally filed direct with Member States' tax administrations using forms that differ in design, change periodically and have little or no standardisation or automation assicated with them. Even so, in some, but not all Member States, long form claims must be processed via a domestic financial institution. In all long form reclaim cases, statutes of limitation vary by Member State as does the length of time that a Member State takes to pay reclaims out. These vary from a few weeks (e.g. Germany) to, anecdotally, over twenty years (e.g. Italy).

Irrespective of the relief methodology, all Member States require claimants to provide identification both that they are residents of a treaty State and that they are entitled to the benefit of the treaty. This is typically achieved today using certificates of residency issued by Member State's tax administrations either as explicit paper certificates or as stamps on treaty claim forms. Again, there is no standardisation and no automation within tax administrations even though busines would be willing and eager to invest in and adopt such.

In all of the above, the legal framework in which investors and financial institutions have to work is based on the terms of the appropriate double tax treaty, assisted by a range of supporting frameworks e.g. ECJ, Competent Authority, whose purpose is most commonly to resolve disputes in specific cases, than to facilitate a simplification.

### 2.2 *Relevant Existing EU Legislation and Case-law*

Arguments can be mobilised to develop a smooth legal basis for the national legal measures of Member States on procedural rights, and on the treatment of foreign resident taxpayers and their financial intermediaries in the particular areas of:

1. the standardisation of documentation;
2. coordination of the national public authorities in the exchange of information and in the facilitation of the provision of evidence;
3. the fair determination of the liability of financial intermediaries;
4. the application of a simplified relief at source system.

Taxation is within the competence of the Member States, although the power of the Member States to tax must be exercised consistently with primary and secondary Community law. It comes from such a division of power between the Member States and the European Union that tax matters cannot be harmonised unless the Member States reach consensus in adopting explicit harmonisation measures. There are still alternatives to the traditional way of harmonisation. This can first be due to the development of the forms of enhanced cooperation and the effective enforcement of rights between the authorities of the Member States. Furthermore, the ECJ has been scrutinising the legal practices of the Member States in the light of the effective protection of taxpayer rights since decades. As a result of it, the Member States have been asked, from time to time, to remove restrictions on the fundamental freedoms, and streamline their legal systems.

The current situation is far from adequate, is inefficient and, in some cases, systems may even be in violation of EU law. More should be done in the area of withholding tax relief procedures to create a single and integrated EU financial market.

Although the progressive removal of tax barriers would be useful, the financial industry that benefits from the home licensing system of financial service-providers must not dispense with all-encompassing, more systematic and categorical harmonisation. It has been still a problem that the single European passport that has been introduced in the financial law area cannot be extended to fiscal matters unless the Member States agree to adopt an appropriate legislative instrument of harmonisation. That would be necessary for entirely removing the barriers of non-harmonised national tax law to the freedoms of capital and services to be exercised in European capital markets. The withholding tax procedures the market players experience are burdensome, and at times even discriminatory. In the following chapters, both the non-traditional ways of harmonisation and a proposal for the concept of a harmonisation Directive will be discussed.

# Part 2 - Comparative International Environment

This Part reviews other parallel situations and their respective solutions, in particular the US and OECD.

## 3. Comparison to US Tax Regulation

The withholding tax system in the United States has a number of common principles to those proposed by the T-BAG Group in this Report and also the O.E.C.D. The practical experience of the T-BAG Group in complying with those principles provides valuable information which can help Member States develop efficient policies and procedures that meet the needs of both governments and business, while at the same time enabling investors to benefit from improved relief procedures.

The US has two separate chapters of its Internal Revenue Code ("IRC") that are relevant to this report – Internal Revenue Code ("IRC") Chapter 3 and IRC Chapter 4. Chapter 3 encompasses the system known to most as the Qualified Intermediary ("QI") regime (that also deals with non qualified intermediaries ("NQI"s)). Chapter 4 contains the so-called Foreign Account Tax Compliance Act provisions that were adopted on March 18, 2010 as a part of the Hiring Incentives to Restore Employment Act (colloquially known as "FATCA"). Both of these chapters of the IRC involve common principles - documentation of ultimate beneficial owners, information reporting to the U.S. tax authorities, withholding on income distributions based on certain rules, information reporting and associated control and oversight procedures. They are however completely separate chapters of the IRC with different rules and *very* different objectives. It is important however, to be aware that the US government is on record as having an objective to ultimately converge the procedural aspects of IRC Chapters 3 & 4 in an effort to streamline processing for financial institutions.

The QI regime has been in force since January 1st 2001 and has the objective of providing a relief at source tax environment based on foreign (i.e. non-US) financial institutions entering into a QI-agreement with the IRS. The QI agreement lays down documentation and due diligence requirements that must be met to grant domestic or treaty relief from US withholding tax and to identify US individuals and trusts that are reportable on a recipient specific basis to the US tax authorities. The QI agreement also imposes certain information reporting requirements and allows but does not require QIs to assume withholding obligations. Control and oversight is organised under the QI agreement through a regular Agreed Upon Procedures ("AUPs") review by an external auditor. While institutions that do not sign an agreement with the US government are not subject to a QI contract, they are subject to the overarching terms of the regulations themselves. NQIs are subject to more restrictive and complex disclosure requirements than QIs.

In contrast, the provisions of FATCA came into force on January 1st 2013, although some obligations come into effect at later dates. The regulations have as their main objective the proper identification and reporting of the foreign accounts of US persons by foreign financial institutions (FFIs). The US is one of a few jurisdictions which claim a right to tax the global (as opposed to US-sourced) income of their Citizens. Chapter 4 is thus designed to address failures of US Persons to disclose this global income required under domestic US law ("tax evasion"). To address this tax evasion issue, FATCA is designed to place an obligation on foreign financial institutions to

identify and document *all* payees, and subsequently to report certain income of those it finds to be US Persons. FATCA also provides for a 30% withholding tax on certain payments received by FFIs either because the financial institution failed to meet its obligations, did not *agree* to meet such obligations in contract and/or because account holders refuse to provide required documentation or information.

In that regard, these two Chapters of the US IRC, while apparently similar in many respects, are actually very different. Chapter 3 (QI) is a withholding tax relief regime designed to allow the correct level of tax to be withheld on US sourced income payments based on exemptions and/or double tax treaties between the US and its partners. Chapter 3 also includes an information *reporting* regime with a limited scope (in view of both the limitation of the scope of QI agreements to US securities held on QI designated accounts and the possibility to report most clients on a pooled basis). Chapter 4 (FATCA) on the other hand, is a tax evasion oversight system targeted at US persons with undisclosed (and therefore potentially un-taxed) global income.

In the twelve years since implementation, business has learned many lessons from implementing the QI regime. In their consideration of an Authorised Intermediary ("AI") system, Member States should capitalise on this experience.

FATCA, on the other hand, is seen by business as being, at best, disproportionate, (i) because of the lack of a true risk based approach, to solve the issue of foreign account based tax evasion and (ii) due to the considerable cost to implement changes to existing customer on-boarding checks.. In many cases they also create significant legal conflicts either between domestic national law, EU law and US law for financial institutions and/or between financial institutions and their customers. In response to significant lobbying by the industry and many governments (including the EU) highlighting the legal obstacles that FATCA creates, the US, in the final regulations, created a two-tier approach by negotiating and agreeing bilateral intergovernmental agreements ("IGAs") designed to address these legal and privacy issues.

Financial institutions established in countries that have entered into an IGA with the US will not be subject to the FATCA provisions as contained in US domestic law but must instead comply with the provisions of the IGA entered into by their country of establishment. There are essentially two different IGA models. IGA Model 1 provides for reporting by local financial institutions to the local tax authorities that will transmit the information to the US tax authorities. A Model 1 IGA can be reciprocal or non-reciprocal. In its reciprocal form, the IGA requires information exchange from financial institutions established in both countries regarding holders of accounts maintained by those financial institutions that are resident in the other country. For this purpose, US citizens are required to be treated as US residents. In its non-reciprocal form, a Model 1 IGA provides for the exchange of information on US account holders only. A Model 2 IGA provides for direct reporting by local financial institutions to the US tax authorities when account holders consent to such reporting. Non-consenting account holders are initially reported on an aggregate basis but the US tax authorities are entitled to make a group request to the other country's tax authorities to obtain detailed information regarding the account holders included in the pool reported.

In both QI and FATCA one of business's biggest concerns is not just the way in which the rules are put into practice, but also the degree to which the tax authority concerned engages with the financial community to explain and help the development of workable solutions that meet both regulator's and business' needs.

Following the US trait, certain countries are starting to consider adopting regimes similar to FATCA. The UK has signed a tax information sharing agreement with the Isle of Man similar to IGAs – under which both the governments will automatically exchange information on tax residents on an annual basis. The UK has further announced that it would pursue similar negotiations with other countries, and that the approach would closely follow the IGA.

Whilst the T-BAG Group focuses in this chapter on granular implications of regulation, we also note in the conclusion of this Chapter, that this is a very complex area and that there is the need for education and engagement, especially in the E.U. context which has the added complexity of different laws, languages and cultures.

## *3.1 Qualified Intermediaries*

### 3.1.1 Control & Oversight

Any withholding system that permits foreign institutions to act as withholding agents, needs to have control and oversight processes. The US QI model uses three principles. The first establishes the obligations of foreign financial institutions, by contract, as the first element establishing the framework of control. The second ensures that the foreign institution is meeting its obligations, usually achieved through oversight by an authorised independent third party. The third ensures that the objectives of the system are not being abused either by incorrect identification of beneficiaries, entitlements or by inappropriate withholding or by means of formalised information reporting in cascade allowing for reconciliation with reports prepared by upper-tier custodians.

There are several aspects to the way that the US has implemented the enforcement and oversight regimes that the T-BAG Group wishes to comment upon.

#### (i) Contracts

In order to be permitted to be a foreign Qualified Intermediary ("QI") and therefore withhold tax on behalf of the US Treasury, financial institutions must sign an agreement with the IRS ("QIA"). QIAs have a fixed term of six years. Failure to re-apply for QI status leads to a minimum two year period without QI status.

*For industry this requires contract management resource. If a* contract *is the preferred method, the T-BAG Group would suggest that a standardised E.U. Authorised Intermediary ("AI") Contract be developed and that renewal is automatic unless termination is triggered by one or other parties to the agreement. Tax authorities should commit to not impose obligations other than those specified in the relevant agreement (cf.in the case of the QI regime certain obligations followed from frequently asked questions published on the IRS website and from internal IRS instructions incorporated in Industry Memoranda) and to provide for realistic implementation deadlines when changes are made to the contract).*

### (ii) Audit v. AUP

Each QIA requires that the QI undergo an Agreed Upon Procedure ("AUP") twice during the six year term of its QIA. Under the QI regime, unless the QI requests an IRS audit, the AUP applies and the QI is to be audited by a designated external auditor. The T-BAG Group considers AUP to be a more appropriate mechanism than audit conducted by the local tax authorities in cross-border situations given the legal issues that cross-border audits may create. In addition, the T-Bag Group prefers self-certifications over external audits. It is key that adequate audit guidance be provided and the specific procedures are defined by the tax authorities enabling business to comply at a cost proportionate to the risk.

At the same time it is worth noting that the EU Authorised Intermediary regime proposal looks to achieve the same overall outcome as the OECD's Tax Relief And Compliance Enhancement (TRACE) Implementation Package. Whist the OECD TRACE programme currently suggests an approach of agreed upon procedures, similar to QI we also considered IRS notice 2010-60.

In this notice US Treasury notes that verification is crucial to achieving stated goals, but acknowledges cost should be reasonable. In this connection, it references the AML / KYC and similar regulatory rules as being similarly dependant on verification but as permitting audits that are either by external or internal auditors and that are not pursuant to agreed upon procedures. This is in contrast to the QI requirements. Reliance on written certifications by senior management is also mentioned as a potential verification tool.

In particular we recommend that the experience of QI's and external auditors or the IRS with respect to overall effectiveness cost and efficiency of external audits be considered in the development of the verification process. Further to the extent possible, verification processes of different regimes should perhaps be integrated. We also believe a simple verification process should be considered which is not one size fits all, but rather includes several different approaches to verification (some more reliant on internal verification than others) which can be applied to AIs, as appropriate, depending on their overall record of tax risk management and compliance.

More importantly the verification process should not rely on audits by external auditors. Based on the experience of QI's such audits are costly and time consuming. It is essential that the costs of implementing an AI regime (including the costs of verification) should be as reasonable as possible to assure participation and compliance. Therefore, the utilisation of external audits should be extremely limited. In light of the above, a verification process relying on internal verification by AI's (if supported by sufficiently robust procedures, processes and testing) should be viewed as a viable and preferable alternative.

Under the QI regime, alternatives to external audits relying on internal controls and testing have been permitted in certain situations. Under IRS Procedure 2002-55 a QI may request a waiver of the external audit requirement if it has demonstrated substantial and robust internal controls with regard to its compliance with the QI agreement. Instead of an external audit, such a QI may perform an independent internal review. This internal review would include testing, checks, or other

procedures deemed to be appropriate to determine whether the QI is compliant. The revenue procedure provides the QI may apply to the IRS for clearance to use this internal review process by submitting a formal description of the proposed testing program.

*This does however, in the European context, highlight the need for a standardised AUP acceptable across Member States.*

**(iii) Waivers**

The US tax law recognises that some QIs may have relatively low amounts of US sourced reportable income. This not only represents a low risk of tax evasion and under-withholding, but also a risk that the cost of complying with AUP requirements can be financially and administratively onerous and disproportionate to the tax and risk involved. Therefore, under the QI rules, a QI can apply for a waiver of the AUP requirement based on threshold of reportable amounts in the audit year or based on the annual internal review program established by the QI. Three waivers are available, each with different information and procedural requirements: (1) if reportable amount does not exceed $1m, (2) if the reportable amounts exceed $1m but does not exceed $4m, and (3) if the IRS approves QI's request to have its internal audit department perform the audit and report to the IRS

*To provide an* incentive *for maximum acceptance of a simplified system, the T-BAG Group would recommend some method whereby low risk entities are either exempted from AUP or have a lower level of compliance burden.*

### 3.1.2 Documentation

The US system permits financial institutions to apply for QI status when they are established in a jurisdiction the KYC rules of which have been approved by the IRS. To that extent, there is an implicit reliance by the IRS on the fact that a foreign institution (QI) is subject to its own domestic regulatory oversight.

The US also subscribes to the concept of self-certification using either a Form W-9 for its own (US) residents or a Form W-8 for non-US persons. There are several issues that cause business problems when using self certifications:

1. There are different forms in the W-8 series (BEN, ECI, EXP and IMY).

   *Having multiple forms causes account holders confusion as to which form they should be completing and incurs cost for business associated with checking that the form is correct according to any other information they hold about the account holder. Costs are also incurred by business for training staff on how to analyse the forms and how to classify account holders based on the information provided by account holder.*

2. The US W-8 forms have a life span of three years from the end of the year in which signed, unless the recipient can obtain a US domestic tax identification number (TIN).

*This causes business challenges and cost associated with tracking the validity of documents on the one hand or the administrative task of obtaining a US tax ID for their account holder on the other. It also requires adjustments to reporting, withholding tax variances etc.*

3. The forms can be used to assert entitlements under different income types. Part 1 of the W-8, for example, can be used to assert entitlement to an exemption for payments of portfolio interest even though Part 2 may be incomplete or incorrect. Equally Part 2, used to claim an entitlement under double tax treaty, requires certain account holders to know the exact clause in the relevant treaty under which they are claiming the entitlement.

   *Whilst business agrees that one form to serve multiple purposes is a good thing, the construction and instructions for such forms should be very clear to avoid large numbers of invalid forms due to a lack of understanding.*

4. The forms must be delivered in paper form. Although there is an e-signature program under which, through a Memorandum of Understanding between a QI and the IRS, a "wet" signature is not required.

   *The T-BAG Group would prefer, if originals are required, that they be required only of the institution acting as the custodian of the investor and that others in the chain with a need for such documentation be allowed to rely on suitably standardised electronic versions. Better is to allow for self-certifications that are compatible with all onboarding and communication channels (physical, internet, phone, ...) and that allow for integration in account opening or other existing processes.*

5. Each form is "owned" by the institution to which it is provided and would not, in the normal course of business, be available to any other institution. So, a single beneficial owner with multiple accounts may be providing several self certifications to different institutions.

   *The T-BAG Group notes that this is both a disincentive for beneficial owners and a risk that minor differences between forms create different tax results at different institutions such that the end investor suffers.*

6. Substitute forms, including forms in foreign languages. That allows institutions with account holders who do not speak or read English to use substitute form W-8. Provided that at least the same data is present on the substitute as is present on the original IRS approved form, and provided that English version is also included.

*The T-BAG Group is generally in favour of the self-certification principle. However, simplicity and standardisation will be key to a successful system. The T-BAG Group proposes an E.U. standardised self certification, available in different E.U. languages and capable of being received, stored and transmitted electronically (including signature) as the preferred model. It ought to be possible to integrate self-certifications in existing account opening processes. Such a form should have unlimited lifespan provided there are no material changes in circumstances that would affect the intent of the form.*

### 3.1.3 Withholding

In the US system withheld tax is paid to the US Treasury (as opposed to information reports which are *submitted* to the IRS).

**(i) Withholding Agency**

Foreign institutions who are QIs can withhold US tax on US sourced income either directly as "Withholding QIs" ("WQIs") or indirectly via a US Withholding Agent or upper-tier QI if they are "Non-Withholding QIs" ("NWQIs"). Most QIs today are non-withholding preferring to use a US Withholding Agent ("USWA") to remit tax to the US Treasury on their behalf. However, this causes operational issues as there are two available systems enabling the USWA to know how much to withhold on any payment (given that it does not know who the beneficial owners are). These are (i) segregated pool accounts in which assets are segregated into "tax rate pools" prior to or on record date and (ii) withholding rate pool statements ("WRPS") made by the QI to the USWA on a payment by payment basis between record date and pay date identifying the proportion of the income allocable to a particular tax rate. Please note that when a QI does not assume backup withholding (which is the withholding that must be applied when a US individual has not provided the required Form W-9) responsibilities it must provide a copy of the Form W-9 containing the personal details of its customer to its upper-tier custodian.

**(ii) Source**

The US regulations apply only to US source income, the definition of which presents challenges for business. While much income can be easily identified as to its source, there are occasions where the source is not clear. Heretofore, issuers have not generally categorised their distributions, leaving the matter to the industry to research and determine. This leads to the risk that different institutions, faced with the same income, define its source differently and thus withhold differently. This also impacts the consistency of information reporting.

**(iii) Standards**

The US has over 20 codes representing various income types as well as other codes representing exemptions, exceptions etc. While coding is a good thing to encourage automation, the T-BAG Group would support an ISO standard to apply to coding of income types.

**(iv) Deposits**

The US provides several mechanisms for the depositing of tax. The most used is a direct portal to US Treasury (EFTPS).

*With respect to source of income and standards, the T-BAG Group would support a requirement on* issuers *of income to include a categorisation of their income, at least by country of source, using some standardised coding system.*

### 3.1.4 Information Reporting

Information reporting is a fundamental concept in establishing a withholding system based on foreign financial institutions acting as withholding agents (QIs).

**(i) Cascade Nature**

The US information reporting system, at least for non-US residents, is cascade in nature. This means that each entity in the chain must report to the IRS the US source payments made In principle, the IRS reconciles these reports (i) to the amount actually deposited at the US Treasury and (ii) upwards and downwards in the financial chain ending with the beneficial owner (in the case of a non-qualified intermediary ("NQI"). If payments were simple in nature, this system would work well. There are some problems however. For example, some issuers can re-classify their income after the end of the tax year. The regulations do provide a mechanism to address this (and any under or over-withholding) through "amended reporting". However, the IRS provides just one date (March 15$^{th}$) on which *all* participants in the financial chain must file their reports. This single date is not workable in practice when a chain of intermediaries is involved. This has led to various commercial methods being used to solve the problem, all of which causes the cascade system to be inherently flawed.

*The T-BAG Group has no issue with cascade reporting providing the rules and time frames given for allowing each participant in the chain to reconcile its books, receive and manage changes and make its final reports are adequate.*

**(ii) Paper v. Electronic**

Currently the US system supports both paper and electronic reporting at the same time, with electronic being mandatory for filings containing more than 250 forms.

*This causes problems and cost both for business and for the IRS. The T-BAG Group would support a fully electronic system over paper.*

**(iii) Domestic residents v. non-resident aliens**

For income sourced in the US the IRS requires separate reporting of US sourced income to its own residents (Form 1099) on a recipient specific basis and to non-residents (Form 1042-S) on a pooled basis (with certain exceptions). There are differences in the reporting requirements in terms of how income is pooled for non-resident reporting (1042), as well as different forms required (originals for 1099, downloadable for 1042).

*All these different* systems *cause business an administrative burden and cost.*

**(iv) Pooled v. non-pooled Reporting**

In some, but not all circumstances information reporting can be pooled in nature (aggregating all income paid to all beneficial owners of a particular type of income subject to the same income tax rate into one report) which benefits business by being simpler to administer. However, the system is not smooth and causes many institutions to be non-compliant. Errors caused by variations in the way reporting is

constructed and/or understood mean that the principle of the cascade system in its ability to reconcile payments and tax withheld within a chain, can be damaged.

*The T-BAG Group does not support pooling of reporting for authorised intermediaries but suggests that any proposed reporting system be at beneficial owner level and simple enough to administer so that most, if not all intermediaries are likely to join the AI model.*

**(v) Definition of "electronic"**

The US has over time, changed both the format of data required as well as the delivery method. In Europe, it is likely that what constitutes "electronic" may vary by market. Currently "electronic" can mean a .pdf file, a spreadsheet or an ASCII file.

*The T-BAG Group* would *support a single ISO compliant standard e.g. XML/XBRL for format and an "open" approach in which such standardised information (claims, reports etc) could be delivered by any convenient, but secure carrier.*

### *3.2 FATCA*

The US has, for some time, had concerns that its taxpayers are evading taxes on their global income through the medium of foreign accounts, particularly in jurisdictions where secrecy laws acted to protect their identity. The use of collective investment vehicles, nominee accounts and other structural ways to hold investments can also act to create a barrier to transparency. The QI regime is perceived by the US authorities as only partially addressing such concerns and as lacking transparency with respect to non-US income of US persons. In addition, the relatively low number of foreign financial institutions that have entered into QI agreements with the IRS is further considered by the authorities as creating a barrier to transparency. Industry believes this view results, to some extent, from a misconception of NQI status and obligations.

FATCA was designed by the IRS to address these systemic problems. However, after the publication of the Proposed Regulations (RIN 1545-BK68) Relating to Information Reporting by Foreign Financial Institutions and Withholding on Certain Payments to Foreign Financial Institutions ("FFIs") and Other Foreign Entities issued on February 8, 2012 ("Prop.Regs.") it became clear that there are a number of operational issues prohibiting or making it unreasonably difficult to achieve compliance with FATCA provisions. Recognising the need for co-operation in combating international tax evasion, but also the legal and practical restrictions, as well as costs of foreign financial institutions (FFIs) involved in achieving full compliance of FATCA, a number of countries expressed an intention to negotiate an IGA with the US, based on Model IGA agreements. Two Model IGA agreements have been developed so far.

The purpose of both Model IGAs is to reduce the compliance burden imposed on FATCA partner country FFIs and to overcome the obstacles created by local legislation regarding data privacy and withholding. Under Model 1 IGAs, the FFIs are required to report to their domestic tax authorities, whereas under Model 2 IGAs the FFIs will exchange information directly with the IRS. More importantly, under both Model IGAs the withholding is limited to the very narrow circumstances and applies only with regard to taxpayers and financial institutions that do not comply with the

FATCA provisions. Specifically, an FFI is only required to withhold 30% of any US source withholdable payment made to a non participating FFI, FFI that is not FATCA compliant, or to an account holder that has not provided the required information or a waiver to the FFI.

The US Treasury Department has concluded several IGAs and announced that it is engaged in discussions with more than 50 jurisdictions that are interested to enter into IGAs.

Following the US trait, certain countries are starting to consider adopting regimes similar to FATCA. The UK has recently signed a tax information sharing agreement with the Isle of Man similar to IGAs – under which both the governments will automatically exchange information on tax residents on an annual basis. The UK has further announced that it would pursue similar negotiations with other countries, and that the approach would closely follow the IGA. Russia has expressed similar intent to negotiate IGA-like agreements.

Many other countries have similar underlying principles under which they claim a right to tax the global income of their residents. This trend is likely to continue as global financial pressure on tax authorities results in a focus on ensuring disclosure so that tax revenues are optimised. It is natural to presume that EU Member States will feel a similar pressure.

*The T-BAG Group understands the rationale of FATCA, however, the Group generally considers that the implications of FATCA are disproportionate with the intent and benefit for a number of the reasons given below. The comments apply to the FATCA regime under the Final Regulations and under the Model IGAs, unless indicated otherwise.*

**(i) Multiple FATCA Regimes**

As a result of the processes described above, currently there are a number of FATCA models being advanced at the same time. As a result, multi-national financial institutions with subsidiaries and branches in various countries are faced with implementation of the base FATCA model in the Final Regulations, IGAs negotiated based on Model 1, IGAs based on Model 2, and the IGA-like agreements entered into by other countries. Furthermore, even though the IGAs are negotiated on the basis of models, differences, however slight, exist among all negotiated IGAs. Some IGA's, the UK for example, includes a 'future-proofing' provision that the UK IGA will always benefit from any better terms offered by the US to any other FATCA Partner in an IGA. Notwithstanding that agreements may differ it is also possible that each country's implementing legislation will vary leading to different interpretations of key points. This means that IGAs and country specific legislation will need to be constantly monitored.

*The plethora of the FATCA models makes it extremely difficult, confusing and costly for financial institutions to comply with the law, making it practically unworkable. A standardised approach is recommended.*

**(ii) Definition of Financial Institution**

In order to expand the number of entities over which the IRS can exert direct contractual control, FATCA and Model IGAs identify four different types of entities that can be defined as a foreign financial institution ("FFI"). Some of the definitions are rather broad and include entities that normally do not fall under the laws governing regulated financial entities. Because of the broad definition, FFIs that do not maintain financial accounts will also be captured even though they would not having anything to report on. The net effect of this expansion is that there are expected to be *upwards of a million* entities that fall into the definition of FFI and, consequently, be subject to the identification, reporting and withholding obligations. In addition, since the definitions of the FFI differ under Final Regs. Model 1 IGAs and Model 2 IGAs, the same Financial Institution could have a different FATCA status in different jurisdictions.

**(iii) Contracts**

FFIs will be required to sign an agreement "FFIA" which forces them to identify account holders, and, for certain legal entities, also the controlling persons of such account holders for the purpose of identifying any US persons, and imposes reporting and withholding obligations. Of particular interest is the development that the IRS has established a web based method for FFIs to register and sign FFI Agreements, subject to experience, this concept has merit in an EU context. Under FATCA, the requirements will generally be incorporated into local law for FFIs in IGA countries whilst other FFIs must enter into an FFI agreement. No expiration dates have been set for FFI agreements

*There is concern that the* IRS *will be unable to cope with the number of FFIAs and equally, entities that were not previously defined as FFIs will have little or no capability to comply with the identification, reporting and withholding requirements. Furthermore, the same financial entity could be treated as an FFI in one country, but not in another. Therefore, as structured, the FFI concept is unworkable both for the IRS and business.*

**(iv) Waivers**

FATCA provisions contain two contentious waiver issues which potentially put financial institutions in a position where compliance to US law may cause them to be in breach of local law.

FATCA recognises that there may be occasions where local law prohibits the reporting of the information required under FATCA that could identify US Persons (even if there are none in fact). To that extent, FATCA provisions require the FFI to obtain a waiver of such law from its account holders to permit such reporting.

*This creates potential legal issues where it may be illegal for a resident account holder to provide a waiver of its own law, albeit failure to do so would place it in breach of US law.*

In addition, the Final Regulations require FFIs to close accounts where such waiver is not provided or where the account is otherwise treated as recalcitrant.

*There are concerns around these provisions including (i) potential contravention of SEPA regulation with respect to the right to have an account, (ii) changes to terms and conditions to accommodate a waiver principle may be open to legal challenge and (iii) the principle of a waiver may be deemed to be discriminatory.*

**(v) Interpretation of US status**

While opening *the* investment community to more transparency, FATCA also requires a more rigorous interpretation of legal status than FFIs have previously been familiar with. Financial Institutions currently apply KYC and AML rules but these are not deemed sufficient in all circumstances by the US to identify a US person. Additional tests might be applied by relationship managers for both entities and individuals, repeated regularly and to a substantially deeper level than currently will require significant training, additional systems builds and education of customers who may not see relevance to answering questions about a country they are not invested in.

Furthermore, to *the* extent that other countries are also negotiating IGA -like agreements, the financial entities would need to identify the country of the tax residence of their account holders based on various other sets of rules and definitions.

*If financial institutions are required to apply different rules by different EU countries for the same purpose, this will add to the cost and administrative burden, assuming that it is workable. A standardised approach is recommended.*

**(vi) Explicit Certification of Compliance**

While the compliance with the QI rules is achieved through AUPs, FATCA compliance is likely to be more restrictive. Under Final Regulations, FFIs are required to explicitly certify that they have complied with FATCA obligations. Under the IGAs the approach is different as the supervisory role will be mainly with the local tax authorities of the country of establishment of the FFI. The US tax authorities are however entitled to make inquiries directly to the FFI where it has reason to believe that minor errors have been made that resulted in incomplete information reporting or other infringements. In case the US tax authorities have determined that there has been significant non-compliance then it will notify the other contracting state and require it to apply the penalties as applicable under local law to address the non-compliance. In case the enforcement actions do not resolve the non-compliance within a period of 18 months, the FFI will be blacklisted as a non-participating FFI which will cause it to suffer a 30% US withholding tax on certain payments received.

**(vii) Withholding tax as a penalty**

FFIs are required to withhold 30% or any US source withholdable payment made to non-participating FFIs and recalcitrant account holders (account holders who have failed to provide required documentation or information). In addition, the Final Regulations and Model IGAs have reserved a right to expand the withholding to apply also on certain non-US source payments and sales proceeds. The IGAs have restricted instances whereby withholding is required by offering reporting alternatives.

Much has been said about the reporting model over the anonymous withholding model. Routinely, governments have expressed reporting as the desired outcome.

Clearly today with investors foregoing tax relief due to the complex and costly processes tax authorities are not obtaining information on their residents cross border investments. T-BAG envisages that implementation of the AI regime will increase investor information reporting.

**(viii) Documentation requirements and client identification procedures**

The client identification and documentation procedures that apply under FATCA are extremely complex. The complexity is caused in part by the fact that the regime provides for a very high number of different statuses for legal entities and because of the complex combination of documentation requirements, due diligence requirements, documentation validity rules and presumption rules. The proliferation of statuses for legal entities is caused mainly by the very broad definition of financial institutions and the vagueness of concepts such as passive non financial entities. The other issue with the documentation requirements under FATCA is the fact that these requirements are not sufficiently aligned with prevailing KYC procedures.

We should also point out that FATCA does require full paper file reviews in certain instances whilst financial institutions usually have well developed client databases containing up-to-data identification data. Strict procedures and requirements generally exist for the maintenance and amending of these data. In spite thereof, FATCA only authorizes electronic searches in limited circumstances thereby creating significant costs for financial institutions.

The T-Bag Group believes that the EU should advocate an approach whereby clear and realistic definitions are used and whereby documentation requirements be aligned with existing KYC requirements. In addition, financial institutions should be authorized to rely on their electronic data for due diligence purposes.

The T-BAG Group recognises Member State's legitimate wish to implement a relief at source and reclaim model for non residents in an efficient way. Member States would also naturally wish to provide a disincentive to their own residents from evading taxes.

The T-BAG Group's overall view of FATCA is that, while the intent is understandable, it is not appropriate for the withholding tax system to be used for such a purpose and that other mechanisms exist e.g. information sharing agreements, competent authority et al which individually, in concert or adapted in some way would be more appropriate and effective for the intended purpose.

In comparing and contrasting the US QI system described here with the observations of business in the other chapters in this report, the Group notes that the US system, while conceptually simple is, in practice, still complex and costly at the operational level twelve years after its original implementation. The T-Bag Group does, however, support the principle that foreign intermediaries be allowed to act as withholding agents and offer withholding tax relief at source and that KYC documents can be relied upon for granting relief at source in many instances. To avoid the complexity of the QI and FATCA regimes, at the Member State and E.U. level, a strong focus on the principles of standardisation and use of electronic storage and transmission is recommended together with a well thought through and continuous education and guidance programme to provide for a high adoption rate by financial institutions.

# 4. Comparison to E.U. and O.E.C.D work

The O.E.C.D has in parallel with the EU, worked on improved withholding tax procedures. In January 2013 the O.E.C.D. approved a standardised system of effective treaty and domestic relief (the TRACE Authorised Intermediary System) including a complete implementation package 5for countries to move forward ("the TRACE Implementation Package or IP). Section 4.1 provides some background on the work conducted within the OECD that has led to the approval of the TRACE Implementation Package. Section 4.2 and Appendix 5 compare the work with the EU recommendation in further detail.

## *4.1 Context*

The OECD work on withholding tax relief procedures was initiated as a result of a growing awareness of governments and the financial industry of the need to improve existing withholding tax relief procedures. In 2006, the CFA established an Informal Consultative Group[6] (the ICG), composed of representatives from governments and the financial industry. The aim of the ICG was to analyse the compliance and administrative difficulties surrounding claims for tax treaty benefits on investment income derived through financial intermediaries, and to consider whether there were administrative procedures that could be adopted to streamline those claims.

In January 2009, the ICG issued a report entitled "Possible Improvements to Procedures for Tax Relief for Cross-Border Investors" (the ICG Report). The ICG Report identified a number of inefficiencies in withholding tax relief procedures for cross-border portfolio investments and set out best practice recommendations for such procedures.[7]

The ICG Report recommended that countries develop systems for claiming treaty benefits that allow "Authorised Intermediaries" to make claims from withholding agents for relief at source on a "pooled" basis on behalf of their customers that are portfolio investors. One of the major benefits of such an AI system (variations on which have been adopted by a few countries over the past decade) is that information regarding the beneficial owner of the income is maintained by the intermediary with the most direct account relationship with the investor, rather than being passed up the chain of intermediaries. The ICG also recommended that further work be undertaken to promote substantial uniformity across source countries with respect to the procedures to be followed by the AIs.

At the beginning of 2009, the CFA approved the establishment of a "pilot group", again composed of representatives from governments and the financial industry (the Pilot Group), to develop standardized documentation for the implementation of the "best practices" recommended by the ICG. In February 2010, the Pilot Group

5 Available at http://www.oecd.org/ctp/exchangeofinformation/TRACE_Implementation_Package_Website.pdf

6. The Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors.

7. "Report of the informal consultative group on the taxation of collective investment vehicles and procedures for tax relief for cross-border investors on possible improvements to procedures for tax relief for cross-border investors", 12 January 2009, available at: http://www.oecd.org/dataoecd/34/19/41974569.pdf.

produced an "Implementation Package"[8] containing model documents to be used by any country willing to implement the AI system recommended by the ICG (the Implementation Package or IP).

In February 2010, the CFA released the IP as a discussion draft for public comments. It also approved the creation of two working groups: (i) the TRACE Group, made up of government representatives from OECD countries, to take forward the work on the IP and develop a plan for multi-country adoption of the AI system (working in close consultation with a dedicated Business Advisory Group); and (ii) a joint government/business group of IT experts to ensure that the proposed information reporting and automatic exchange of information processes that are part of the recommended AI system can function effectively.

In December 2012, the TRACE Group approved a revised version of the Implementation Package which takes into account the comments received on the Pilot Group's draft.

The TRACE IT Expert Group has:

- developed an electronic format for the information to be reported by financial institutions to tax administrations and for the exchange of information between tax administrations. This format, using eXtensible Markup Language ("XML"), is called the TRACE XML Schema. XML is the modern industry standard mark-up format, as used in the OECD Standard Transmission Format (STF), and the EU format developed from STF for the Savings Directive, FISC 153.
- designed and conducted a Proof-of-concept test to confirm that the TRACE XML Schema fulfilled the objectives of the TRACE project from the perspective of the financial intermediaries and the tax authorities of the source and residence countries involved recommended the use of secure file transfer protocol ("sFTP") as the transmission method for reporting by financial institutions to tax administrations and for the exchange of information between tax administrations, or alternatively, the existing EU CCN system for exchange between tax administrations, where available.

In January 2013 the CFA endorsed the Implementation Package and approved further work in two areas: a) exploiting synergies between TRACE and other reporting regimes (including FATCA, the Common Model for Residence Country Reporting and any EU follow-up work on the FISCO Feasibility Study; and b) developing a plan for a multi-country adoption of the Authorised Intermediary system and assisting countries progress towards adoption.

### *4.2 Comparison of the E.U. Recommendation with the TRACE IP*

The E.U. Recommendation and the IP support a withholding tax relief system that has many similar features. However, there are also some differences. The main differences are that:

1. the Recommendation only provides the general framework of such withholding tax relief system and does not always specify how each of the features of the

8. "Possible improvements to procedures for tax relief for cross-border investors: implementation package", 8 February 2010, available at: http://www.oecd.org/dataoecd/20/36/44556378.pdf.

system should be put in practice, while the Implementation Package is very detailed and consists of a self-contained set of all the agreements and forms that would pass between a source country, the AI and the investors participating in the system; and

2. the scope of the Recommendation is limited to E.U. resident investors, investing in securities from another E.U. Member State through a financial institution established in a E.U. Member State or EFTA Member Country, while the IP is designed to apply in a global context.

The IP is fully consistent with the E.U. Recommendation and could serve as a basis for any country wishing to implement the Recommendation. In the long term, the E.U. specific context might possibly justify different approaches for putting the E.U. Recommendation into practice, from those followed in the IP. In particular, one could consider:

1 E.U. financial institutions to be authorised by the E.U. Member States in which they are established, similar to MiFID (instead of E.U. source countries);
2 Submitting Authorised Intermediaries to an audit by the tax authorities of the E.U. Member State in which they are established only, audits which would be recognised by the source E.U. Member States (instead of submitting them to a review by an independent reviewer and/or audit by the source country tax authorities)
3 Requiring E.U. based AIs to report investor specific information via the tax authorities of the Member States in which they are established, who would exchange the information with the relevant source and residence countries (instead of reporting to the source country as envisaged by the IP).

Appendix 5 provides a detailed comparative analysis.

*From a business* perspective *and in a strictly E.U. context, some of these options may present benefits. However, unlike the approach followed in the IP, each of the above options would require the adoption of a Directive. As a result they would not offer any solution in the short to medium term. As a practical matter, this potential approach would need to be tempered by adopting enhanced tax relief arrangements that can be implemented in the most expeditious manner. In addition, these options would only function in an E.U. context: other solutions would need to be adopted for the cases in which the investor, issuer or intermediary is located outside the E.U. Consideration should therefore be given to the risk that operating two separate systems in parallel may increase costs for tax authorities, financial intermediaries and investors.*

# Part 3 - Proposed Solutions

## 5. Guidance

Financial intermediaries may provide some form of a withholding tax service to their clients that hold portfolio debt and equity investments. This is especially relevant for custodian banks. The custodian's tax services in this context focuses on the collecting and filing of tax documentation to enable investors to make a relevant claim under either a treaty or domestic law. In order to claim the benefit of a relevant treaty, it is common for there to be some form of documentation to evidence entitlement. As set out in this report, this ranges from the provision of a certificate of tax residence to a treaty claim form or income payment information, among others. Such a tax service can take on a number of forms but may include the following tasks:

1. the collection of tax documentation from clients;
2. the submission of relevant tax documentation to local withholding agents;
3. the submission of reclaims to a source country tax authority; and
4. the renewal of such tax documentation under power of attorney.

Custodian banks may service a diverse client base – e.g. clients from multiple residence countries; of different legal form; and business purpose.

Whilst ultimate *responsibility* for any tax relief claim will normally reside with the beneficial owner, an FI will wish to check such entitlement. As noted within this report, the question of treaty eligibility or otherwise can be a difficult area in certain circumstances. The areas of difficulty typically arise on questions of interpretation around whether the claimant is:

- a person for the purposes of the relevant treaty;
- a resident within the meaning of the relevant treaty; and
- and the beneficial owner of the income received.

Typically the *qualification* of entities such as partnerships, corporations, Collective Investment Vehicles, pension funds, Trusts, Charities, International organisations and others causes the greatest concern. Specifically the complexity of the qualification of CIVs has been recently recognised and addressed in the O.E.C.D Report on 31st May 2010 titled The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles We also note the on-going work of the OECD in clarifying the meaning of the term 'beneficial owner' in articles 10, 11 and 12 of the OECD Model Tax Convention[9]

The authors of *this* report believe that any question of liability in the context of the application of an incorrect withholding tax rate on a portfolio investment income payment has to be placed within the context of the need for appropriate clear guidance from the Authorities. Increased effective guidance will enable all participants – i.e. both FIs and claimants of lower rates of withholding tax - to appropriately commercially allocate risk to the appropriate party.

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[9] http://www.oecd.org/ctp/taxtreaties/Beneficialownership.pdf

Clear guidance issued by the respective competent authorities enables investors to determine any tax relief to which they may be entitled and enables FIs to determine the parameters of any tax relief service and the respective rates to apply.

In turn this will reduce risks and compliance costs for investors, FIs and Governments. Finally it will enable tax authorities to concentrate their investigations on risk rather than the more standard portfolio investor entitlements. Of course it will still be necessary for Tax Authorities to have the ability to provide investor specific rulings or opinions but certainty in the first instant will increase confidence for all participants.

*The owner of the guidance is by nature the competent authority of the source country. However, a standardised format and a central information platform hosted by the E.U. will increase the effectiveness for the Single Market significantly. We suggest that a streamlined ruling process be devised where generic entity level rulings can be requested to confirm whether such an entity is entitled to either a lower rate of withholding tax either under a treaty or domestic law. Such rulings should be limited to portfolio investors and subject to certain conditions and appropriate limitations. Such conditions could include a general tax avoidance limitation.*

*In order to request such a ruling, the ruling applicant should be required to provide the following: an overview of the entity – this should include references to source country tax law and commercial law where applicable and include confirmation as to whether the entity is opaque / transparent under source country tax law; and whether the entity is subject / liable to tax in the source country on income received.*

*To provide for a level playing field and to avoid different stances being taken by FI's, we recommend that rulings of* this *nature are made publicly available on the internet. This should assist tax authorities in that it will avoid duplicative requests for clarification.*

# 6. Relief at Source

This aim of this chapter is to provide an overview of proposals for Relief at Source, introducing the notion of *contracts* signed between the different parties that could lead to a short/mid-term solution.

## *6.1 Authorised Intermediary Agreement*

Bilateral agreements, i.e. voluntary adoption, can be seen as a practical route to establish financial *intermediaries* as AIs. While E.U. regulation through Directive is an alternative, this would be limited to E.U. participants. In any case, contracts would be needed for non-E.U. participants and the financial industry recognises that an E.U. regulation may be difficult in the short term.

The different types of bilateral AI agreements could be described up as follows:

1. Local to Local
2. Residency to Source Country

### 6.1.1 Local to Local

Under this option, the country of residence of the intermediary would grant its resident financial institutions the ability to act as an authorised intermediary (AI) for the purpose of information reporting and as a withholding agent. In this case, the home country would act as agent for the *source* country. In the short term, this would initially be possible for E.U. or EFTA resident intermediaries.

In the mid/long term, non-E.U. intermediaries meeting criteria to be defined / agreed by E.U. Member States would be treated the same as an E.U. or EFTA resident intermediary. Business suggests that criteria could be by reference to EOI provisions. The pre-requisites of such a system would include:

1. Source country must have agency agreements with all countries in which AIs are established.
2. All Member States to agree on the content of the agreement.

There are benefits to a local-local AI system:

1. Each resident intermediary would have to sign only one contract. This solution would lead to the kind of simplifications encouraged by the E.U. Commission Recommendation of 19$^{th}$ October 2009;
2. Familiarity with governing law.

However this solution may actually require changes in local law to account for procedures in case of under-withholding.

### 6.1.2 Country of Residency to Source country

In this model an intermediary would sign a contract with each source country. The benefits of this methodology include:

1. This solution can be quickly implemented by the source countries who wish to do so (no dependency on countries of AIs);
2. Non E.U. or EFTA resident intermediaries would be treated the same as residents. This would avoid discrimination of third countries.

However, E.U. or EFTA resident financial institutions would have to sign up to 27 contracts. In order to ease the process, one solution would be a package including all agreements and forms to be filled in, duly signed and forwarded to the competent authorities.

### 6.1.3 AI Contract Model

The main elements which would need to be taken into account for such agreements are:

1 Governing law;
2 Procedural requirements;
3 Nature of income covered;
4 Withholding agent status;
5 Terms of reporting obligations;
6 Authority to disclose;
7 Liability;
8 Penalties;
9 Rates of withholding (which could be delegated to guidance);
10 Documentation requirements (including retention period and validity);
11 Statute of limitations covering both claim and review period;
12 Control and oversight (to include detail of reviewer);
13 Dispute procedures;
14 Term of contract and termination provision.

This list is not intended to be definitive.

## *6.2 Documentation*

Given (i) an AI Agreement to codify the obligations of AIs, together with (ii) adoption of the principles and guidelines issued by the various Member States, (iii) appropriate documentation of beneficial owners and (iv) the use of TIN's to facilitate exchange of information, withholding agents would be able to withhold at the correct relief rate at the time that the distribution is made to the investor.

With reference to (iii), documentation to evidence status and legal form of those investors claiming relief either 'at source" or in a tax reclaim, in the main are the same. These are discussed at some length in Chapter 9 and include:

1 KYC documents;
2 Powers of Attorney;
3 Certificates of Tax Residence.

### *6.3 Information Reporting*

In order to meet the tax authorities' requirements, AIs will be asked to provide detailed information about reportable payments and beneficial owners. The frequency of the reporting could be on monthly basis with a year-end summary report.

Having reviewed the US withholding tax system, certain conceptual elements do seem to provide both access to reconciliation of payment chains between AIs as well as disclosure. However, other elements were deemed by the T-BAG Group to be disproportionate to an efficient system.

The T-BAG Group proposes that the AI closest to the beneficial owner be responsible for reporting at beneficial owner level directly to the source Member State. The AI would, in the envisioned model, report upwards to other AIs in the payment chain at a pooled level.

#### 6.3.1 Reporting Models

Information reporting could be implemented in a number of ways as exemplified below

**Reporting via source state of income**

In this model, the AI issues a report directly to the source state of income payment. It is up to the source state of income payment to issue the information reporting to the residence state of the final beneficial owner, whether automatically or via specific request. This option brings a harmonised solution amongst E.U. Member States.

**Reporting via home state of AI**

In this model the AI issues reports to its home state Tax Authorities. It is up to the home state to report/forward the information reporting to the source state of income payment and to the residence state of the final beneficial owner.

**Reporting via source state of income and residence state of beneficiary**

The intermediary issues a report to the source state of income payment and to the residence state of the final beneficial owner.

Of the described reporting models the Group prefers the source state of income model as it is most compatible with current practices in global context.

#### 6.3.2 Standards and Automation

Transmission of report data is currently not coordinated nor standardised between tax authorities. The T-BAG Group strongly recommends that attention is given to these subjects in any planned implementation. However, the T-BAG Group recognises that each Member State has different levels of standard and automation in place ranging from standard paper delivered forms (which vary by Member State) to electronic data files (which vary in format and delivery mechanism). Therefore, the work involved in moving towards a more harmonised, standardised and automated system will be

different for each Member State and may be a significant driver for the speed with which a phased voluntary adoption can occur.

**(i) Standards**

Current standards employed by industry include both ISO (currently ISO15022 and planned ISO20022) and XML amongst others. Equally, there are several options open to Member States for the transmission of such standardised information. In cases where reporting is comprised solely of data an ISO standard is feasible, although financial intermediaries are not expected to have fully implemented ISO20022 for several years and there are no ISO15022 standards that currently address the reporting requirements. XML and its subsidiary XBRL offers more opportunities for rapid implementation. XBRL is a subset of XML and is designed for financial reporting and is congruent with ISO20022. The US and UK already mandate in regulation that financial reporting must be in XBRL format. IRS in FATCA Final Regulations preamble also notes that it intends to mandate XBRL as a standard for information reporting under IGAs commencing in 2015. As there are over 50 countries with which the US is currently negotiating IGAs, it is likely that, by the end of 2013, most of the key investment markets will be familiar with the concepts of XML/XBRL. This technology may therefore be useful as a bridging technology, quick and low cost to implement and congruent to the longer term solution of an ISO20022 standard.

**(ii) Automation**

Most, but not all, banks are members of the Society for Worldwide Interbank Financial Messaging ("SWIFT") which operates a secure messaging computer network over which data can be moved between participating users. However, to date, no tax authorities have a presence on the SWIFT network for the receipt of reports. In addition, while standardised in principle, the reality of ISO standardised messages sent over the SWIFT network suffers from consistency problems in that counterparties on the network can independently agree on the location of data in messages passed between them. The theory is that a message of any given type, if it meets the ISO standard should be readable by any other institution on the network. However, this is not the case. Were this model to be replicated in the information reporting between AIs and Member States, it is possible that each Member State could specify its own format for the location of data within messages. Thus each AI sending reports to up to 27 tax authorities could find it costly and challenging to send a report containing the same data elements, but differently ordered, thus removing almost all of the benefits of standardisation and automation which the financial services industry would want.

The internet also offers opportunities to develop secure data transmission methods and many emerging types of institution, notably central securities depositories, are or have developed proprietary systems with underpinning ISO standards. In this respect XML and XBRL also offer flexible and rapid implementation approaches. XML establishes a taxonomy (or dictionary) by means of which any party can transmit to any other party, a document containing 'tags' to identify where specific data elements appear in the document. This means that an XML/XBRL Information Report can be formatted visually in any way a tax authority wishes and the required data within the document is machine readable irrespective of where the data element appears in the

document. The T-BAG Group recommends that, in any information reporting requirement, Member States mandate XML/XBRL formatting, to allow both tax authorities and AIs flexibility to adopt standardisation and automation in an efficient way and at their own pace.

*The T-BAG Group* recommends *that the information to be provided by the financial intermediaries should be standardised in line with the O.E.C.D and limited with respect to content.*

### 6.3.4 Report Content

In order to fulfil the requirements of Member States, give comfort about the proper execution of the AI agreement and prepare the field for a quick and efficient audit, we propose that the following information would have to be included into information reports. As mentioned before some information can be provided on a monthly basis, and others on an annual basis:

2 AI Identification number
3 Payee – intermediary
   a. Payee – details
   b. Name
   c. Intermediary approval number
   d. Address
4 Payee – beneficial owner details
   a. Name
   b. Home State TIN
   c. Country of Residence
   d. Address
   e. Beneficial Owner Type
5 Income Payment Details
   a. Issuer tax residence (country of taxation)
   b. Nature of Income (standardised income type code)
   c. Unique security identifier
   d. Gross amount
   e. Net amount
   f. Tax rate

Intermediary reporting to upstream agent / intermediary (pool reporting)

1 AI Identification number
2 Pool reporting rate
3 Income payment details
   a. Issuer tax residency (country of taxation)
   b. Nature of Income (standardised income type code)
   c. ISIN
   d. Gross amount
   e. Net amount
   f. Tax rate

All of this information should allow any future reconciliation between exemption granted and tax withheld and deposited with the respective tax authorities.

The possibility for an AI to shift part of its responsibilities (information reporting responsibility and/or withholding responsibility) to another upstream AI, or third party, should also be anticipated in order to allow small AIs to contract and be compliant at low cost. The contract, reporting and audit scope should take this possibility into account.

### *6.4 Withholding*

The T-BAG Group considers that tax should be paid to the source country directly in order to avoid having member states transferring money between them and obliging them to maintain multilateral reconciliation processes.

### *6.5 Control and Oversight*

All Member States can be expected to require a control and oversight methodology to ensure proper and efficient operating of an AI system. In essence there are three differing possibilities:

1. Audit of AIs by the home country tax authority
2. Agreed Upon Procedure ("AUP") conducted by independent
3. Self verification

It should be noted that there is a legal difference between an 'audit' and an "Agreed Upon Procedure". An audit requires an auditor to give a legal opinion upon which the recipient can rely. There are associated liabilities with an audit process which do not exist within an AUP model. Equally, a greater range of independent, suitably qualified firms would naturally be available to AIs within an AUP model than would be available within an audit model. An AUP is simply a procedure agreed upon by a tax authority. Whilst an independent firm, who may well offer traditional audit services, can conduct an AUP, they would not be acting in the legal capacity of auditors.

In respect of the audit by the local authorities, this is unlikely to be an acceptable solution in the current financial climate. For example, we understand that some tax authorities may be reluctant due to staff and budget constraints – we are currently seeing this in the development of enabling legislation for Intra Governmental Agreements in the UK. Another approach could be to appoint an external auditor but this would result in transferring the audit cost to the AIs.

In light of the above, we recommend an AI verification process which similarly relies primarily on internal controls and self audits for those AI's that have previously demonstrated a record of compliant behaviour, strong internal controls and verification processes. The extent to which the AI verification requirements rely on internal processes could depend on an AI's overall risk profile based on, amongst other factors, its approach to tax (and overall) risk management and its history of compliance under domestic regulation. Specifically, the following factors, amongst others, could be considered in determining whether a particular AI's verification process should be reliant on internal controls and processes:

1. Compliance record;

2. A record of internal KYC / AML reports supported by robust internal controls and including annual reporting to local bank regulators;
3. An established verification process relying on internal health checks or similar testing programs which is part of the AI's existing tax risk management framework and which is performed by an independent department of the AI;
4. The inclusion in internal audits of testing (in addition to the above health checks) to verify compliance with existing operational tax requirements
5. A process involving annual internal compliance certifications by the affected departments to an independent department with oversight responsibilities and / or by the AI to its parent company.

An internal AI compliance verification process would include the following features:-

1. Detailed written AI internal policies and procedures;
2. Identification of responsible parties within each affected business and operational unit and other key controls;
3. Required regular testing (by an objective independent business unit and / or internal audit) meeting specified requirements and documented in written test reports;
4. Regular certifications (perhaps every second or third year) to the home country competent authority by senior management of the participating AI (supported by sub certifications from affected businesses) regarding compliance with internal procedures; and
5. In the event the certification reports an un-remediated material deficiency and if, in the discretion of the competent authority an audit is necessary to assure remediation of that deficiency, an external audit firm would be engaged by the AI to do an independent audit. The scope of the audit would be pre-agreed by the AI and the competent authority and would be limited to the identified problem area (e.g. business line or legal entity) and issues. The audit would focus, as appropriate, on assuring that the remediation is implemented, the deficiency corrected, and the procedures are otherwise compliant.

# 7. Tax Reclaims

## *7.1 Overview*

As this report notes, the preference is for Member States to adopt a unified simplified withholding tax relief at source system i.e. one solution for all European Union source Member States that provides for a withholding tax relief at point of payment process for non-resident portfolio investors.[10] We have not addressed claims made by domestic investors – i.e. investors resident in the same country as the source payment. We recognise that this solution may involve significant change for certain countries in that new process and procedures would need to be adopted. As a point of record, this report is supportive of the Commission's Recommendation of 19th October 2009 on withholding tax procedures.

The following section makes certain suggestions as to how existing documentation requirements, in order to benefit from a reduced withholding tax rate either under a double tax treaty or domestic law, could be simplified and so lead to processing efficiencies for both claimants and intermediaries.[11] Such simplification would also have benefits for tax authorities in that it should reduce processing costs and, to some degree, improve the general compliance environment.[12] The proposals outlined below should be seen as evolutionary in that they represent a progressive step towards the final goal of a unified simplified tax relief system. In assessing whether or not this progressive step should be adopted, tax authorities should consider whether it would make better sense to go directly to the end solution as set out at [insert x-reference].

As a general matter, reduced rates of withholding tax on portfolio securities income are claimed through one of two means – tax relief at source (i.e. at point of income payment) or through a retrospective tax reclaim.[13] Tax relief at source may, in certain markets, be obtained without detailed tax documentation but more commonly documentation will be required. Such documentation may encompass treaty claim forms and certificates of tax residence etc. Tax reclaims will generally require a tax treaty claim form to be completed and such a form may also require further documentation such as a certificate of residence, tax voucher etc.

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[10] Portfolio investors in this context is taken to mean those investors qualifying under a relevant double tax treaty for the general rate of withholding tax on dividends. i.e. investors holding a shareholding meeting a minimum threshold as envisaged under Article 10 2(a) of the O.E.C.D Model Tax Convention on Income and on Capital will not be said to be a portfolio investor.

[11] The Economic Impact of the Commission Recommendation on Withholding Tax Relief Procedures and the FISCO proposals", 24.06.2009 ("FISCO 2009"), Chapter 5.

[12] Refer to FISCO 2009, chapter 4

[13] FISCO, First Report 2006, "Fact finding study on Fiscal Compliance Procedures Related to Clearing and Settlement within the E.U.", ("FISCO 2006"), chapter 2.2.2

It is worth noting that relief at source is the preferred withholding tax claim method for both investors and intermediaries as tax reclaims, by their very nature, possess a number of specific issues.[14] The key issues being:

1. Reclaims have a time value of money cost;[15]
2. Reclaim timeframes can vary from market of investment to market of investment,[16] but a recent study by the British Bankers' Association noted that indicative timeframes for receiving a reclaim can range from 2 weeks to a minimum of ten years;[17]
3. As reclaims typically require a form to be produced and income specific information recorded, this means that such reclaims have a higher processing cost compared with tax relief at source that allows for one time documentation (or documentation requiring only periodic renewal).[18]

The O.E.C.D in a recent report made further comments with regards to the problems associated with tax reclaims and this report endorses those comments.[19]

Treaty forms, whether relief at source or reclaim, have certain core similarities in terms of the information requested from the claimant. As such, this report argues that it should be possible to standardise documentation, for both purposes, to support a common tax claim process and deal with source country concerns around receiving sufficient evidence of entitlement to a lower withholding tax rate. The benefit of having one form to access multiple markets of investment would reduce complexity within the European Union and should remove a barrier to cross-border investment.[20] We would further argue that standardised documentation should significantly reduce the costs of processing different paper forms and documents. These costs incurred in processing forms has been estimated as ranging between €50 – €140 per refund claim.[21] As such, any simplification should result in lower costs for all participants in the process – i.e. government, intermediaries and investors.

A significant benefit of simplification should be an increase in claims by eligible investors. This increase may result from the investor better understanding the claim process or the reduction in the cost to claim leading to a low value claim being economically worthwhile.

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[14] FISCO, Second Report 2007, „Solutions to Fiscal Compliance Barriers Related to Post-trading within the E.U." ("FISCO 2007"), chapter 2.

[15] FISCO 2007, chapter 3.

[16] FISCO 2009, Annex 3.

[17] http://www.bba.org.uk/policy/article/international-custody-tax-liasion-group-market-standards-2010/tax/

[18] FISCO 2006, chapter 2.3.2.2.

[19] Report Of The Informal Consultative Group On The Taxation Of Collective Investment Vehicles And Procedures For Tax Relief For Cross-Border Investors On Possible Improvements To Procedures For Tax Relief For Cross-Border Investors 12 January 2009, page 9.

[20] FISCO 2007, chapter 2.3.

[21] FISCO 2009, chapter 5.3.

*This report recommends, in line with the recommendation made by the 2007 FISCO Report, that a simplified form for all Member States (i.e. one form covering all Member States) should be developed.*[22] *Such a simplified form should not be restricted to E.U. investors. That is any investor investing into an E.U. country should be able to use this standardised form. The simplified form should be issued with associated detailed guidance from each member state so that any points of detail or definition have appropriate guidance allowing both investors and intermediaries to understand and operate the claim process.*

Any such form should be capable of dealing with domestic exemptions (e.g. pension, charity etc. result of ECJ cases; infringement procedures etc.) and not be limited to claims pursuant to a double tax convention. Furthermore, we believe that international organisations or sovereign entities should be able to use any standardised form. We accept there may be some difficulties in designing such a form but guidance may represent a potential solution. For example, there may be policy issues around whether sovereign entities may benefit from any domestic law provisions providing for sovereign immunity. A recent O.E.C.D paper described those issues and such concerns could be dealt with through guidance – e.g. it could be clearly stated that the doctrine of sovereign immunity will not apply to income paid to a trading entity regardless of the fact that it is ultimately owned by a sovereign body[23].

The benefits of providing a standardised form can be seen to be multi-dimensional in that it will have an impact on all participants in the claim process:

1. the investor – simplification should lead to a greater degree of clarity around eligibility and reduce costs of compliance. At present, where investors are presented with an unclear claim process this may lead to investors having to take tax advice (and so a cost) or forgoing tax relief that they would otherwise be entitled to;
2. financial intermediaries – a standardised form with clear guidance should reduce costs of compliance, reduction in processing costs and make it easier to offer a service; and
3. government - a simplification of the claim process may lead to increased capital inflow where investors, previously unable to obtain tax relief on portfolio income, may make investment decisions based on an increased post tax yield.

Increased clarity around the claim process should help improve the general compliance process and reduce the potential for erroneous claims arising from a lack of familiarity with the claim process.

### *7.2 Common Reclaim Form*

In designing a standardised claim form, capable of use in both a relief at source and reclaim situation, for use within all European Union countries, consideration should be paid to existing tax claim forms. Following a review of existing tax forms from Member States it is clear that existing tax forms have a common core set of questions

[22] Same as FISCO 2007, chapter 2.5.2.

[23] http://www.oecd.org/document/57/0,3343,en_2649_33747_44120057_1_1_1_1,00.html

used to determine eligibility for lower withholding tax rates. Appendix 7 details the output of this review and the findings have been summarised below. In essence a withholding tax claim will require both the provision of core data and a number of key representations to be made by the claimant.

The recurring data / representations can be said to cover the following common elements:

1. Claimant details (e.g.. name and address);
2. Claimant type (i.e. individual, company, pension fund etc);
3. Home country identification;
4. Resident country tax identification number (TIN);
5. Treaty Article under which claim is made;
6. Whether the investor meets the provisions on any limitation of benefits provision ("LOB");
7. A beneficial ownership representation;
8. A "no treaty abuse" representation;
9. A "subject to" / "liable to" tax representation; [24]
10. Whether (in the context of a company) the claimant operates through a branch in the source country and whether the income received is attributable to that branch;
11. Whether the beneficiary holds above a certain threshold of the share capital of the distributing company; and
12. Details regarding the income paying event (i.e. security details, distribution dates etc);
13. Amount of the claim
14. Details of the refund mechanism (account number for credit of refund).

It is worth noting that the recurring data and representation can be seen to be broadly consistent with the data / representations envisaged under the O.E.C.D's draft Implementation Package.[25]

For completeness it should be noted that documentation simplification is a significant process enhancement issue but thought does need to be given to the wider process. As the Commission's recommendation stated in respect of refund procedures:

"Such procedures should comprise the following:

(a) permission for information agents or withholding agents to submit refund applications to the tax authorities of the source Member State on behalf of the investors;
(b) use of a single contact point for the introduction and handling of all the refund applications and publication of the relevant information on refund procedures on a website, in at least one language customary in the sphere of international finance;

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[24] As an aside, we note that this term has given rise to issues in practice with a lack of a clear definition. Such difficulties should be dealt with by clear guidance issued at a source country level.

[25] http://www.oecd.org/dataoecd/20/36/44556378.pdf

(c) use of common formats for refund applications which would be able to be filed electronically;
(d) refunding in a reasonable period of time and normally, at least, within 6 months of receipt of the refund application by the relevant tax authority, provided that all necessary information is available."[26]

This report endorses these recommendations.

### *7.3 Know-Your-Customer ('KYC') information*

Financial institutions are generally obliged to perform certain KYC due diligence at the account opening stage and on certain specified transactions on an on-going basis. However, it should be noted that KYC as a general matter is not geared towards establishing either tax entitlements or tax residency. As such KYC has an inherent limitation in this regard.

Whilst the FISCO Report proposed that for individuals it may be sufficient to rely on such KYC in order to determine access to tax relief, the financial institutional preference is for a tax specific form. Such a form eliminates potential ambiguity or incorrect determinations based on partial information. Source countries would need to be in position to satisfy themselves that such KYC would be sufficient to determine access to reduced rates of withholding tax. Whilst it should be noted that several countries – such as Austria and Germany – have for a number of years applied a KYC-rule for interest payments made to non-resident investors, in practice however this can be difficult. The U.S. Qualified Intermediary regime currently allows for KYC information to be used in the place of tax specific forms.

Where such KYC is deemed to be sufficient, it is likely that the financial institution will need to inform the claimant that will make certain tax based determinations – including residency and beneficial ownership – based, in part, on the country of birth and identity documentation provided. There are some issues with this approach, not least that individuals are potentially highly mobile and financial institutions may in practice default to asking for additional evidence to support a claim for a reduced withholding tax rate. Therefore this would mean in practice that KYC may be insufficient and may require additional information and evidence to support a claim. This report therefore suggests that if Governments believe that KYC can be used to determine treaty access, the inherent limitations should be accepted and should any incorrect treaty determinations be made based on such KYC this should not give rise to any financial penalties or similar for the financial institution.

### *7.4 Powers of Attorney*

Tax authorities should accept the use of a power of attorney ('PoA') by a financial intermediary or third party service provider acting on behalf of the beneficial owner. In order to operate a modern outsource solution for clients, this is key requirement and need for industry. In practice currently today the PoA is used, unless the source country does not accept their use, by an intermediary to complete documentation on

[26] Commission Recommendation Of 19th October 2009 On Withholding Tax Relief Procedures - Page 6.

their client's behalf. In order to do so an intermediary will ask their client to provide certain standing representations. We recommend that the standardised reclaim form be capable of completion under such a PoA.

### *7.5 Certification*

A number of forms require home state tax authorities to validate the form. i.e. by means of either stamping a form, to evidence treaty residence, or by providing a certificate of tax residence to append to the form. This process is in itself is a time consuming process for all participants in the process. We further note that ever increasing cross-border investment is likely to mean that burdens on tax authorities to provide such certification will increase. This point was raised at first by the FISCO Group in its "Second Report on Solutions" in 2007.[i27] FISCO requested to abolish the currently customary certificates of residence that need to be issued annually by the responsible tax office of the beneficial owner. This idea was raised in a recent O.E.C.D report that noted:

"the U.S. Internal Revenue Service processed 2.4 million certificates of residence for the fiscal year ending 30 September 2007, over a 60 percent increase from just a few years earlier. This procedure has been centralised into one service centre, and a user fee has been instituted to help defray the costs. As a result, the costs of granting and claiming treaty benefits have been shifted from the source country (the one asking for the forms) to the residence country (the one providing the forms) and then charged to the investors, who benefit from the treaty. There has been some debate over whether this is an appropriate allocation of costs".[28]

It is also worth noting that the use of certificates of tax residence is in itself of questionable value. Again a recent O.E.C.D report commented on the limitations of this certification process as a checking tool for the source country. [29]

*This report* concurs *with both the Second FISCO Report and the O.E.C.D report and proposes that any requirement for a certificate of residence be eliminated to be replaced by a common standardised form of self certification.*

### *7.6 Collective Investment Vehicles*

It is important to note that certain Member States have placed processes around claims made by collective investment vehicles ('CIVs'). In this context collective investment vehicles means funds that are widely-held, invest in a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established. As a general comment, it is felt that these processes are somewhat unclear both as a legal matter (i.e. whether the collective investment vehicle is treaty entitled in its own right or whether any treaty determination should be

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[27] FISCO 2007, chapter 2.2.8.1.

[28] Report Of The Informal Consultative Group On The Taxation Of Collective Investment Vehicles And Procedures For Tax Relief For Cross-Border Investors On Possible Improvements To Procedures For Tax Relief For Cross-Border Investors, p.13

[29] Report Of The Informal Consultative Group On The Taxation Of Collective Investment Vehicles And Procedures For Tax Relief For Cross-Border Investors On Possible Improvements To Procedures For Tax Relief For Cross-Border Investors, pp.13-14

made at the level of the holder of the units or shares in the collective investment vehicle) and as an operational matter (i.e. how should the process work). Any uncertainty regarding treaty eligibility is especially problematic for a CIV, which must take into account amounts expected to be received, including any withholding tax benefits provided by treaties, when it calculates its net asset value ("NAV"). The NAV, which typically is calculated daily, is the basis for the prices used for subscriptions and redemptions. If the withholding tax benefits ultimately obtained by the CIV do not correspond to its original assumptions about the amount and timing of such withholding tax benefits, there will be a discrepancy between the real asset value and the NAV used by investors who have purchased, sold or redeemed their interest in the CIV in the interim.

In May 2010 the O.E.C.D released its report on "The granting of treaty benefits with respect to the income of Collective Investment Vehicles". Based on this report the Commentary on the O.E.C.D Model Tax Convention includes for the first time statements regarding the application of the Convention on CIV.

According to the O.E.C.D commentary a CIV should be treated as a person and as a resident for treaty purposes if the tax law of the country where such a CIV is established would treat it as a taxpayer.[30] As it is a consistent objective of CIV regimes to ensure that there is only one level of tax at either the CIV or the investor level, there are a number of countries where the CIV is in principle subject to tax but its income may be exempt from tax. Even in these cases the requirements to be treated as a resident may be met if the requirements to qualify for such an exemption are sufficiently stringent.[31] Moreover a CIV defined as a vehicle that is widely-held, hold a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established, will also be treated as the beneficial owner of the dividends and interests that it receives, so long as the managers of the CIV have discretionary powers to manage the assets generating such income.[32]

In order to provide more certainty regarding treaty eligibility of CIVs the O.E.C.D-Commentary concludes that tax authorities may want to reach a mutual agreement clarifying the treatment of some types of CIV in their respective States. With respect to some types of CIVs, such mutual agreement might simply confirm that the CIV satisfies the technical requirements (person, resident, beneficial owner) and therefore is entitled to benefits in its own right. In other cases, the mutual agreement could provide a CIV a administratively feasible way to make claims with respect to treaty-eligible investors.

In light of the importance of certainty regarding the treaty eligibility of CIV this report recommends that E.U. countries consider the recent amendments made to the O.E.C.D Model Convention.

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[30] O.E.C.D-Commentary 6.10, 6.11 to Article 1.

[31] O.E.C.D-Commentary 6.11, 6.12 to Article 1

[32] O.E.C.D-Commentary 6.14 to Article 1

Such considerations should take account of the fact that a high percentage (approx. 75 – 80%) of CIV established within the territories of the E.U. member states are compliant with the Directive 2009/65/EC of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

The Directive contains rules for the authorisation, supervision, structure and activities of UCITS established in the Member States.

For the purpose of the Directive UCITS means undertakings with the sole object of collective investment in transferable securities or in other liquid financial assets of capital raised from the public and which operates on the principle of risk-spreading.[33] The Directive contains obligations regarding the investment policies of UCITS.[34]

UCITS may be constituted in accordance with contract law (contractual funds) trust law (unit trusts) or statute (corporate funds). Not subject to the directive are:

1. Collective investment undertakings of the closed-ended type
2. Collective investment undertakings which raise capital without promoting the sale of their units to the public within the Community or any part of it
3. investment undertakings the units of which, under the fund rules of the instruments of incorporation of the investment company, may be sold only to the public in third countries.[35]

To pursue activities UCITS have to be authorised in accordance with the Directive by the competent authorities of its home member state.[36] Further they are under the supervision of the competent authorities of the home member state.[37]

Given the regulatory framework of UCITS it is unlikely that they will be used for treaty shopping as UCITS are subject to investor protection regulation, have to hold a diversified portfolio and will be widely-held. Considering the intention of the UCITS Directive to approximating the conditions on Competition between UCITS at Community level, while at the same time ensuring more effective and more uniform protection for unit-holders we recommend that UCITS funds should be deemed to be treaty entitled in their own right. The treaty entitlement should be determined by reference to the fund's place of incorporation / establishment. As proposed by the O.E.C.D such entitlement could be clarified by a mutual agreement between Member States.

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[33] Article 1 of the Directive 2009/65/EC.

[34] See Capter VII oft he Directive 2009/65/EC.

[35] Article 3 of the Directive 2009/65/EC.

[36] Article 5 of the Directive 2009/65/EC.

[37] Chapter XII of the Directive 2009/65/EC.

### 7.7 *Automation*

We believe that the recurring data and representations noted above could be used to develop a common form for use by all Member States. However, we note that this reference to a form should not be read as a preference for a physical form (i.e. a paper based solution) and indeed these data fields could be developed as the data set necessary for any e-filing reclaim solution. In line with the comments made above any such form should be produced in an international language used in financial transactions.

This report as a general matter supports electronic filing of tax documentation in order to secure withholding tax relief.[38] Electronic filing in this context is taken to mean the use of the transmission of defined data (the schema) by secure electronic means (the transmission format). A number of Member States, such as the Netherlands and Germany, already provide for a degree of such e-filing, although such e-filing is currently limited to tax reclaims.

There are a number of benefits of moving towards an e-filing solution and such a system should provide for:

- A reduction in processing costs for both intermediaries and government;
- A better compliance regime in that governments will be better able to run database queries and so check data received on a real-time basis; and
- The elimination of a paper intensive process.

The success of moving to an e-solution will largely depend on the solution chosen.

We are also mindful of the O.E.C.D Treaty Relief and Compliance Enhancement Implementation Package. The transmission format and exchange method should be standardised in order to keep costs proportionate to the end goal.

As noted above, a standardised form with a standardised data set would allow for the basic building blocks of a e-filing / e-reporting solution to be developed.

[38] FISCO 2007, 2.2.1

## 8. Exchange of Information

Exchange of information between governments is an essential part of withholding tax systems described in the EU Recommendation as well as the Implementation package developed at the OECD. This section contains a number of considerations in this regard.

### *8.1 Use of Tax Identification Numbers*

Tax Identification Numbers ("TINs") are used to identify tax payers and are an excellent feature for effective control through any tax exchange of information process. This was highlighted in the (Second FISCO Report 2.5). TINs can be useful for processing information received from a treaty partner. The provision of TINs is also important when either making or answering a request or providing information to a treaty partner country by means of spontaneous information exchange since it will facilitate the quick identification of the taxpayer.

In more recent years some governments have sought to introduce TIN requirements for non resident investors seeking tax treaty or domestic law tax relief in a source country. It has been widely documented that this approach raises discrimination concerns highlighting barriers to the principle of free movement of capital.[39]

*The T-BAG Group considers that there are two elements relevant to the use of TINs in the context of this* report*:*

1. *TINs provide Member States an excellent method to optimise exchange of information and to match and reconcile information reporting.*
2. *TINs should be issued by the residence country not the source country*

### *8.2 Legal basis for exchange of information*

It is understood that the E.U. is studying an approach in which financial institutions would report information to their own tax authorities, which would in turn exchange relevant parts of the information with source and residence countries. This contrasts with the OECD AI system where financial institutions would report information to the source countries which would exchange it with the residence countries. Such alternative approaches would work only to the extent the country of establishment of the intermediary has treaties with both source and residence countries of the investors allowing such exchange of information.

The T-BAG group considers that efficient relief procedures should be available to all eligible investors, independent of the treaty network of the country of establishment of their financial institution. Therefore, the alternative approach under analysis by the Commission, if adopted, could mean remote access to the system would disadvantage foreign intermediaries and their customers. Nevertheless the cost for tax administrations and financial institutions to administer both approaches in parallel must be taken into consideration before pursuing such an approach.

# 9. Liability

Within the Second FISCO-Report (2.2.3) the importance of the liability on Financial Intermediaries in their role as facilitators of withholding tax relief mechanisms has been discussed. Consideration however needs to be given to various factors that may result in a deemed tax under-withholding and the need to limit the liability on Financial Intermediaries as a result.

Business did not take into account the legal position with regard to liability for under-withholding across the various E.U. member states. The need for harmonisation and the options available to member states have been documented in [chapter 3]. However, business believes liability arises in the following three areas:

- The party (or parties) with withholding responsibility
- The party (or parties) that are held liable for any under-withholding
- Any factors that may be relevant in determining which party (or parties) are held liable for-under-withholding in different situations.

The following assumes that tax relief has been provided "at source" in accordance with the E.U. recommendations. Different conclusions may be reached where tax relief has been provided by means of alternative "at source" or tax reclaim arrangements.

*Business believes that the determination of liability for under-withholding (i.e. identifying the party that must pay) should be distinguished from the collection of that liability. It does not necessarily follow that the party that collects the liability should be the party that is liable for under-withholding.*

## *9.1 Determination of liability*

Liability may rest with different parties depending on the generic cause of the under-withholding. Based on practical experience the most common generic causes for under-withholding are:

1. Technical issues surrounding the eligibility or otherwise of a particular investor type, where there is no clear guidance from the source country
2. Processing errors by a Financial Intermediary (FI)
3. Incorrect or fraudulent representations by a client of an FI.

*Although in all three cases, the FI might seek to recover the under-withholding and might generally be able to pursue this under its standard indemnity arrangements with its customers, an* ultimate *liability of the FI for an under-withholding only exists with respect to cause 2.*

*Business submits that for under-withholding attributable to cause 1, ultimate liability should rest with the* source *country. For under-withholding attributable to cause 3, we consider that ultimate liability should rest with the client, i.e. the claimant. It is proposed that a FI will be required to operate under the best practice recommendations regarding the "reason to know" standard. By adopting the best*

*practice recommendations liability of the FI under cause 3 should only be created when the FI is acting in collusion with the client.*

*This position is* distinct *from the OECD Implementation Package approach which provides for strict liability for under-withholding for authorised intermediaries (see Appendix 5).*

### *9.2 Collection of liability*

It is recognised that Governments will seek to ensure that they have the ability to recover any tax under-withholding in an effective and efficient manner. It is further recognised that the most efficient approach may involve the Tax Authorities in a source country seeking repayment of taxes from the FI. However, it is submitted that the cause of the liability should be carefully balanced with the obligation imposed on the FI. We believe that there are three recovery scenarios for a source country:

1. **FI unable to recover tax under-withheld**
   - **a.** In the event the FI cannot recover the tax which was under-withheld, business considers that the tax authority should address the request to the claimant directly. Within an E.U. context, the tax authorities have the tools to recover taxes directly from the claimant / taxpayer. This is facilitated under mutual assistance directives within the E.U. the most recent of which is Council Directive 2010/24/EU.
2. **Incorrect or fraudulent claims paid directly to the end investor**
   - **a.** Given that the end investor is the party that has received the benefit of the under-withholding, the under-withholding is solely resulting from its fraudulent/negligent behaviour and the end investor is ultimately responsible for returning the relevant tax to the source country. It follows that the source country should go directly to the end investor as also proposed under option 1 (outlined above). Where appropriate, relevant recovery assistance agreements could be invoked by the source country in cooperation with the residence country to recover the tax.
3. **Other cases**
   - **a.** the source country would go directly to the withholding agent/first FI in the chain who would reimburse the source country. Thereafter it would be necessary for the indemnification arrangements in place between the various parties to be exercised in order to attempt to ultimately recover the funds from the investor. This option is likely to be the preferred option for many source countries. However, we consider this would be the most cumbersome option to operate as it potentially requires multiple indemnification agreements to be exercised in the investment chain. In certain cases such as the inability to recover under-withholding (under recovery scenario 1) from the end investor, business believes that ultimate liability should rest with the source country.
   - **b.** the source country would go directly to the last FI in the chain who would exercise the relevant indemnification agreement to recover the under-withholding from the investor/CI. The FI would reimburse the source country in all cases except where it is unable to recover under-withholding under recovery scenario 1 from the end investor.

*Having reviewed* the *various recovery scenarios business believes that option b represents the optimal approach for recovery of tax not withheld. It is submitted that option b minimises the overall administrative burden by directly targeting the relevant link in the chain. This should ensure the efficient recovery of tax. In addition, business believes that to the extent that FIs have a role in the recovery of taxes, the following matters should also be considered:*

1. *the need for clear guidance regarding the entitlement to tax treaty benefits or otherwise;*
2. *equality of treatment in relation to the liability of an FI and a local withholding agent operating in the source country;*
3. *penalties and fines should be proportionate to the error/fraud committed and any interest penalties should be aligned with the source country central bank rate.*

In conclusion, the party liable for the recovery of tax depends on the reason for the under-withholding occurring. Where information has been supplied incorrectly or fraudulently by the investor, the source *country* should pursue the investor/beneficial owner for the recovery of tax. Where the FI has failed to operate under best practice "reason to know" recommendations or commits processing errors which result in under-withholding, the FI should be liable for the recovery of tax.

# Part 4 - Recommendations of the T-BAG Group

## 10. Final Conclusions

### *10.1 Over-arching Principles*

The over-arching principles that has driven business in researching, discussing and making these proposals to Member States is the need for both governments and business to reduce costs and make the withholding tax system more efficient, reliable and accessible for all those involved in it. The core principles needed to achieve this, wherever possible are: (i) agreement to common simplified approaches, (ii) standards and (iii) automation. So, while the conclusions of this report go into some granular detail about the different elements of an efficient withholding tax system e.g. documentation, liability, exchange of information, reporting and tax reclaims etc, a common thread in many proposals is the development and use of voluntarily agreed standards between Member States and wherever possible for information to be transmitted securely in electronic form.

The T-BAG Group reviewed both FISCO reports, together with an analysis of the US withholding tax system and projects in hand by the O.E.C.D to establish, from experience, some of the best practices that could be incorporated into an E.U. withholding tax system.

The prior FISCO reports concluded that the most effective system for the E.U would be an “Authorised Intermediary” type system in which relief at source would be the base model with optional post pay-date tax reclaims available in all Member States. The framework solution proposed takes this principle and addresses some of the challenges that this concept produces at an intermediate level of granularity. If Member States approve this proposal, at this level of granularity, further work will need to be conducted to produce the finalised framework.

### *10.2 Legal Basis*

In chapter 2 and Appendix 5, the Report outlines several arguments which essentially reach the conclusion that there is no substantive legal obstacle to the implementation of the FISCO Report recommendation nor to the subsequent implementation proposals outlined in this report.

### *10.3 Implementation*

The T-BAG Group believes that voluntary adoption by Member States would be the most effective way to implement the report’s recommendations and that there are self-evident economic benefits to government, investors and business. The alternative method of a Directive would probably take seven to ten years to accomplish (cf. European Savings Directive) and would result in more complexity and cost for governments and the industry in the interim. Some Member States (e.g. Slovenia, Ireland) are already adopting their own variations on an AI model.

A Directive need only be envisioned if it transpires that certain Member States have not taken any voluntary action to adopt the recommendations in a phased approach.

The measure of Member State adoption should be proportionate to the economic benefits/costs. However, the T-BAG Group believes that the degree of cost saving and efficiencies gained by early adopters will be a compelling driver for other Member States. However, a Directive would also be helpful to address binary points.

### *10.4 Summary Conclusions*

As a result, this report makes a series of pragmatic recommendations which the T-BAG Group urges be considered for implementation either by voluntary adoption by Member States *(preferred)* or by Directive.

The principle recommendations flow from the FISCO Report (2010) in which Member States were urged to, and have in principle agreed, to a common policy in which Member States move towards a consistent and simplified withholding tax model based on the availability of *both* tax relief at source *and* post pay date refunds.

In this report, the group has provided more detailed recommendations. Tax relief at source will be applied by financial intermediaries, authorised in contract by Member States, and supported by a simplified requirement for documentation of beneficial ownership, integrated with existing international regulatory principles such as KYC and AML. The group also makes specific recommendations with respect to post pay date refunds. These recommendations focus on improvements to efficiency and use of technology that will lead to a more consistent reclaim process for Member States, intermediaries and investors alike.

Structural changes intended to support this policy include recommendations on improved quality and distribution of guidance from Member States on the interpretation of both double tax treaties and domestic law reliefs, use of common and standardised forms and procedures, adoption of technology allowing for electronic transmission and processing of documentation, clarification of the liability of financial intermediaries and the implementation of control and oversight mechanisms, including annual information reporting and exchange as well as independent oversight. In particular, the report provides (i) specific suggestions for determining the liability of intermediaries in context to the proposed system, (ii) a proposed more formalised and standardised guidance and exchange of information from and between Member States, (iii) suggested content for AI agreements, (iv) proposals for documentation of beneficial owners including self certification of residency, (v) proposals for tax information reporting content and audits as a control and oversight system based on a recommendation for Home State oversight and reporting with exchange of information rules permitting the transfer of such information to the source State.

The T-BAG Group believes that there is ample legal precedent, to allow Member States to harmonise and simplify their withholding tax procedures, as envisioned in the FISCO Report, either on a voluntary basis or via a Directive or both. Due to the difficulties and time frame likely under a Directive based approach, the T-BAG Group favours a voluntary solution adopted by Member States to be implemented in a phased way.

In total, the implementation of these recommendations will achieve the objectives of the Commission and Member States, to improve the efficiency of the markets by

removing the barriers to the free flow of capital resulting from the current inconsistent, fragmented and inefficient relief mechanisms.

# Appendices

## *Appendix 1 Members of the T-BAG Group*

### *European Commission*

| | |
|---|---|
| Patrick Pearson | DG MARKT - Chairman |
| Tomas Thorsén | DG MARKT - Secretary |
| Niamh Carmody | DG TAXUD - Observer |
| Frederica Liberatore | DG TAXUD - Observer |

### *Business and Academic Society*

Lars Afrell, Swedish Sec. Dealers Assoc.
Hugues Besson, Clearstream
Sandrine Cohen, BNP Paribas
Daniel Deak, Corvinus
Gabriele Escalar, Independent
John Everett, HSBC
Matthias Geurts, Independent
Chris Gilbert, Independent
Charles Hellier, Independent
Roger Kaiser, EBF
Gabriele Lange, BVI
Koen Marsoul, Ernst & Young
Ross McGill, GlobeTax
Janne Palvalin, Nordea
Catherine Peyratout, SocGen
Paul Radcliffe, Ernst & Young
Francisco Uria, KPMG
Pat Wall, PwC
Lorraine White, BNY Mellon
Veronique Witte, Euroclear
Richard Young, SWIFT
Klaus Zinkeisen, Independent
Philip Kerfs, OECD, Observer[40]

[40] *OECD officials participated as observers. This Report should not be construed as in any way reflecting the official position of the OECD or the OECD Secretariat.*

## *Appendix 2 Glossary of Terms*

**Abbreviations & Acronyms**

| | |
|---|---|
| AI | Authorised Intermediary |
| AML | Anti Money Laundering |
| ASCII | American Standard Code for Information Interchange |
| AUP | Agreed Upon Procedure |
| CIV | Collective Investment Vehicle |
| ECJ | European Court of Justice |
| EFTA | European Free Trade Association |
| EFTPS | Electronic Federal tax Payment System (refers to US withholding tax system) |
| EOI | Exchange of Information |
| ESD | European Savings Directive (also EUSD) |
| E.U | European Union |
| FATCA | *misnomer:* refers to Title V of the US Hiring Incentives to Restore Employment Act. |
| FFI | Foreign Financial Intermediary (refers to US withholding tax system) |
| FFIA | FFI Agreement (refers to US withholding tax system) |
| FI | Financial Institution |
| IP | Implementation Package (refers to O.E.C.D. work) |
| ISD | Investor Self Declaration |
| ISO | International Standards Organisation |
| KYC | Know Your Customer |
| LEI | Global Legal Entity Identifier for Financial Markets |
| MAD | Mutual Assistance Directive |
| MiFID | Markets in Financial Instruments Directive |
| NAV | Net Asset Value |
| NQI | Non-Qualified Intermediary (refers to US withholding tax system) |
| O.E.C.D | Organisation for Economic Cooperation and Development |
| POC | Proof of Concept |
| PPP | Passthru Payment Percentage (refers to US withholding tax system) |
| QI | Qualified Intermediary (refers to US withholding tax system) |
| QIA | Qualified Intermediary Agreement |
| SWIFT | Society for Worldwide Interbank Financial Communication |
| TIN | Tax Identification Number |
| TRACE | Treaty relief and Compliance Enhancement |
| UCITS | Undertakings for Collective Investments in Transferable Securities |
| VIES | VAT Information Exchange Systyem |
| XBRL | eXtensible Business Reporting Language |
| XML | Extensible Markup Language |

**Terms**

| | |
|---|---|
| Source State | The Member State from which cross border payments are initiated |
| Home State | The Member State of an AI or Beneficial Owner |

## *Appendix 3 Current Situation in Member States*

NB. The numbering used in this Appendix is independent of numbering used in the main body of this report

Prior to any detailed analysis of recommendations, the group felt it important to establish the arguments for the legal basis upon which such recommendations for simplification and/or harmonisation of tax practices. The following two chapters address the following issues:

1. The basis for statutory harmonisation
2. Alternatives to statutory harmonisation
3. Lessons of the ECJ
4. Arguments for a harmonisation Directive

### 1 Statutory harmonisation

Despite harmonisation, disparities remain as a problem for national tax administrations, applying the EC Mutual Assistance Directive and the EC Recovery Directive[40] in the instances as follows:

1. the applicant Member State cannot obtain information under the Mutual Assistance Directive across the border unless it proves that the source of information has been exhausted;
2. under the Mutual Assistance Directive, the requested Member State may be hesitant to provide information with reference to practical or legal difficulties;
3. under the Mutual Assistance Directive, the requested Member State is not obliged to forward information but as swiftly as possible;
4. the applicant state cannot make use of recovery under the EC Recovery Directive in the other Member State unless it proves that it has used appropriate recovery procedures; and
5. it is difficult to find a balance with trustees managing omnibus accounts between secrecy rules and the requirements arising from the efficient collection of taxes; pooling of information industry-wide may also cause difficulties in identifying taxpayers.

Participants of the industry engaged in cross-border capital market transactions are confronted with a number of real-life problems that arise from the insufficiencies of the current fiscal law environment of the cross-border clearing and settlement of securities. These difficulties do not prevent them, however, from looking for alternatives to the traditional way of harmonisation. In this context, legal tools of other than statutory harmonisation are needed.

Member States could be invited to make it possible for the taxpayers resident in another Member State to make use of model agreements with the national tax administration, follow simplified tax administration procedures or apply for advance rulings in standard terms. Also, learning from MiFID, particular emphasis must be

[40] Council Directive 2011/16/EU on administrative cooperation is applicable from 1 January 2013, Council Directive 2010/24/EU on tax recovery is applicable from 1 January 2012.

placed on what is called by MiFID as "Level 4 legislation".[41] Particular accent should thus move to the easy enforcement of rights.

## 2 Alternatives to Statutory Harmonisation

### 2.1 Enhanced Cooperation between Competent Authorities

The Markets in Financial Instruments Directive ("MiFID") refers to the reinforcement of the provisions on the exchange of information, and to strengthening of the duties of assistance and cooperation between the competent authorities.[42] The result of improved cooperation can be, for example, that the tax authorities of the host Member States could agree to require the application of local tax IDs or the appointment of local fiscal representatives. Particular consideration should be given to the advanced level of the exchange of information and the cooperation between the financial markets supervision authorities of the home and host Member States with a view to extending the methods used in the harmonised financial law area to fiscal law. As long as tax barriers can be removed from the smooth operation of capital markets upon clearing and settlement across the border, it will be possible to achieve more effectiveness in the protection of the rights of foreign resident taxpayers and accord more equivalence to foreign resident financial intermediaries. In the absence of the consensus of the Member States to harmonise tax law, particular emphasis can be placed on what is called by MiFID "Level 4 legislation" (under Para. 64 of the recitals, new legislative techniques should be introduced that are based on a four-level approach, namely framework principles, implementing measures, cooperation and enforcement). Multi-faceted Community legislation is a step of doing harmonisation in a more diverse way.

Disparities in national law may constitute obstacles to the smooth operation of the internal market. The question of the development of Community law cannot be confined to that of simple statutory harmonisation. This has been obvious for two decades at least when the state-centred, categorical, comprehensive and detailed statutory harmonisation was replaced by the more relaxed forms of the co-ordination of Member States in Community legislation. There has been even more emphasis placed on the self-regulation of professions and business communities, acknowledged subsequently by Community bodies (in terms of decisions, communications, white papers, etc.).[43] This way, bottom up initiatives, arising from negotiating of legitimate interests and the enforcement of individual rights, have contributed to the development of an additional source of Community law harmonisation.

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[41] Council Directive 2004/39/EC, OJ L 145, 30.4.04, p. 1. Under Para. 64 of the recitals, new legislative techniques should be introduced that are based on a four-level approach, namely framework principles, implementing measures, cooperation and enforcement.

[42] Council Directive 2004/39/EC, Indent 63.

[43] Appropriate examples for this are the FISCO reports (Fiscal Compliance Experts' Group, Fact finding study on fiscal compliance procedures related to clearing and settlement within the E.U.; First Report, Brussels, 2006; Solutions to fiscal compliance barriers related to post-trading within the E.U.; Second Report, Internal Market DG, Brussels, 2007), and the Commission Recommendation on Withholding Tax Relief Procedures [COM(2009)7924 final] that followed them.

The enforcement of rights and harmonisation are interrelated. Insufficiencies in harmonisation may constitute obstacles to the enforcement of rights. In the taxation area, it is a particular problem that no harmonisation has taken place, other than sporadically. Bottom up initiatives of citizens may constitute a source of harmonisation. They can invite national public authorities to form practices that are friendly enough for the purposes of the exercise of fundamental freedoms, while not making changes in national legislation as such. This way, Community law is developed on an evolutionary basis rather than by way of deliberative policy.

## 2.2 Indirect Harmonisation

In respect of its effectiveness in the protection of the rights of domestic resident taxpayers, the applicable national law, compared to that applicable to purely national cases, must not be:

1. less favourable, and
2. less efficient

(see: *Peterbroeck*, *San* Giorgio, 33/76 *Rewe*, *Comet*, *Brasserie du Pecheur & Factortame*).[44]

Removing tax barriers from the smooth operation of the European capital markets could be possible in an indirect as it has been in the area of law on the compensation for the damage sustained due to the payment of taxes not levied consistently with Community law. Streamlining of national law may lead to harmonisation in an indirect way: it is not the laws of the Member States that are approximated with each other directly, but national legislation itself can be developed without positive harmonisation with regard to the possibility of promoting Community freedoms. Harmonisation is, in this way, not the result of the specific intention of the Member States to adopt acts of harmonisation, but the voluntary conduct of the Member States, the consequence of which is eventually more harmonisation even in the absence of political consensus.

Although tax withholding procedures are covered by national law, one can argue by analogy with tort law that the respective national law cannot be less favourable or less efficient in cross-border cases than in purely domestic situations. This means that national legislation is subject to the standards of equivalence (non-discrimination) in the treatment of market players by the authorities and to that of effectiveness in the protection of rights. The problems that are faced by financial intermediaries that are active across the border could be addressed by referring to these principles. Some of these problems include:

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[44] C-312/93 *Peterbroeck*, ECR, 1995, p. I-4599, Para. 12. See reference to the double requirement of equivalence and effectiveness already in 199/82 *San Giorgio*, ECR 1983, p. 3595, Para. 12. They fist appear in 33/76 *Rewe*, ECR 1976, p. 1989, Para. 5, and 45/76 *Comet*, ECR 1976, p. 2043, Para. 13. These standards have been plainly explained in *Brasserie du Pêcheur & Factortame*. Accordingly, national law criteria must not be less favourable than those applying to similar claims or actions based on domestic law, and must not be such as in practice to make it impossible or excessively difficult to obtain rights. See: Joined Cases C-46/93 and C-48/93 *Brasserie du Pêcheur & Factortame*, ECR 1996, p. I-1029, Para. 90.

1. Lack of standardised documentation used either for relief at source or for reclaim that would support a common tax claim process;
2. The request of information by the competent authorities from the financial intermediaries which is not directly available to intermediaries;
3. Placing liability for under-withholding or false information on the intermediary, given that:
    a. Only the intermediary that has the closest relationship with the investor has access to information adequate to the investor's position held in reality;
    b. the intermediary is only able to check the formal requirements of treaty benefits;
    c. the intermediary often finds it problematic to obtain clear and consistent guidance from the competent authorities.

## 3 European Court of Justice practice

### 3.1 Effectiveness Principle

Foreign resident taxpayers should not be excluded "a priori" from providing relevant documentary evidence, enabling the tax authorities of the Member State imposing a tax to ascertain clearly and precisely that he or she is not attempting to avoid or evade the payment of taxes (see: Société *Baxter and Others*, *Laboratoires Fournier*, and later *ELISA*).[45] Similarly, relief at source cannot be precluded if the taxpayer is successful in providing evidence for fulfilling the requirements for the treaty relief claimed.

In cases like *Focus* Bank and *FKP Scorpio*, it was the main problem that foreign resident taxpayers were not granted effectiveness in protecting their rights. As a result, taxpayers were usually prevented from exercising their right to the free movement of capital. They are not only confronted with difficulties in claiming national law or treaty relief, but it can also happen in these cases that they are deprived of their procedural rights. Such mistreatment cannot be upheld in the light of Community freedoms. It has been recently confirmed (in judgment of 5 May 2011 in C-267/09 *Commission v Portuguese Republic*) that the compulsory appointment of a local tax representative who is in receipt of income requiring the submission of a tax return is in breach of the free movement of capital principle.

### 3.2 Proportionality Principle – Taxpayer Liability

The Commission argues in *Rimbaud*[46] that, in respect of the effectiveness in the protection of the rights of foreign resident taxpayers, the tax authorities should

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[45] C-451/05 *ELISA*, ECR 2007, p. I-8251, Para. 96. See also: Case C‑254/97 *Baxter* ECR 1999, p. I‑4809, Paragraphs 19 and 20; Case C‑39/04 *Laboratoires Fournier*, ECR 2005, p. I‑2057, Para. 25.

[46] C-72/09, ECR 2010, p. 00000, Para. 45. See also: "Since Directive 77/799 provides for the possibility of national tax authorities requesting information which they cannot obtain for themselves, the Court has ruled that the use, in Article 2(1) of Directive 77/799, of the word 'may' indicates that, whilst those authorities have the possibility of requesting information from the competent authority of another Member State, such a request does not in any way constitute an obligation. It is for each Member State to assess the specific cases in which information concerning transactions by taxable persons in its territory is lacking and to decide whether those cases justify submitting a request for information to another Member State (*Twoh International*, paragraph 32)." (C-318/07 *Persche*, ECR 2009, p. I-359, Para. 65).

conduct a case-by-case assessment of the information provided by the taxpayer. It has been the standard in the ECJ practice that the justification based on the fight against tax evasion is permissible only if it targets purely artificial contrivances. Accordingly, a general assumption of tax avoidance or evasion fails to justify a restrictive national tax measure.

The retention at source of tax procedure is a restriction on the free movement of capital at least because it discourages the taxpayer to be active in investment in another Member State if he or she encounters difficulties in enforcing treaty benefits. It surely cannot be justified by the general assumption of tax avoidance because – as held by the ECJ – such justification would be in breach of the proportionality principle. Even if the national tax authorities of a Member State are not able to have recourse to the exchange of tax information provided by the tax authorities of another Member State or EFTA country, the tax authorities should conduct a case-by-case assessment of the information provided by the taxpayer to determine whether this information can be verified.

It has a negative impact on taxpayers engaged in cross-border securities transactions that the applicability of the proportionality principle is subject to a case-by-case assessment. It is therefore for each Member State to assess the specific cases in which information concerning transactions by taxable persons in its territory is lacking and then decide whether those cases justify submitting a request for information to another Member State. The domestic tax authorities may well conclude in a specific case that it is not necessary to initiate mutual assistance with the tax authorities of another Member State.

### 3.3 Proportionality Principle - Burdensome Procedures

In respect of equivalence accorded to foreign resident financial intermediaries, the provision of the Swedish law for the fiscal vacuum to be filled in *Safir* by introducing a burdensome procedure of verification applying to insurance companies not established in Sweden, is in breach of the proportionality principle.[47] Where a Member State introduces a burdensome procedure that is only applicable to cross-border cases, such a policy restricts among other things the Community freedom to provide services, discriminating against foreign financial enterprises. This is also the case with financial intermediaries if they are confronted with extra legal requirements associated with withholding taxation, while offering services to their clients who enter the market of another Member State.

### 3.4 Mutual Assistance Directive

In respect of the equivalence accorded to foreign resident financial intermediaries, the principle of proportionality as spelled out in *Danner* and *Skandia & Ramstedt* requires the public authorities to rely on the EC Mutual Assistance Directive whenever

[47] Council Directive 77/799/EEC OJ L 336, 27.12.77, p. 15, as amended significantly by Council Directive 92/12/EC, OJ L 76, 23.03.92, p. 1; C-118/96 *Jessica Safir*, ECR 1998, p. I-1897, Para. 28.

possible, and not to introduce national law restrictions in advance.[48] The reliance on the Mutual Assistance Directive and on the principle of proportionality are issues that are also relevant to the problem of discrimination both against foreign investors and foreign financial intermediaries that are confronted with the retention at source of income tax.

Where the taxpayer is unable to obtain the necessary evidence, because they are not able to approach the competent authorities of another Member State, the local tax authorities are obliged to act and provide the taxpayer with the relevant information. The local tax authorities may thus explicitly be obliged to rely on the EC Mutual Assistance Directive even when the taxpayer is, for objective reasons, prevented from gaining access to evidence. For example, local paying agents with foreign clients may have serious difficulties in approaching the foreign tax authorities. Similarly, the local authorities may not require a taxpayer's local tax ID to be obtained by a foreign financial intermediary where it is easy for the tax authorities to approach the competent tax authorities of the home Member State and check whether the tax ID is authentic.[49]

With regard to the facilities available due to the operation of the Mutual Assistance Directive, the scope of the national legislator in acting and introducing special measures, including restrictions on the legal management of cross-border cases, does not seem to be very wide. As the ECJ explained in *Passenheim-van Schoot*, the mere fact that the taxable items concerned are located in another Member State does not justify the application of an extended recovery period.[50] One can conclude from this statement that the exclusion of the facility of relief at source cannot be justified either by the mere fact that income is derived abroad or by foreigners.

## 3.5 Interpretation of national law with Community law

In respect of the effectiveness in the protection of the rights of domestic resident citizens (or their companies), a national law procedure must ensure, by all appropriate methods, the fulfilment of legal obligations consistently with Community law. Furthermore, the national authorities are obliged to apply interpretation of national law in full compliance with Community law (see for both issues: *Arcaro*, *Marleasing*,

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[48]Council Directive 1976/308/EEC, L 73, 19.03.76, p. 18 (as amended); a major amendment was made by Directive 2001/66/EC, L 175, 28.06.01, p. 17; C-136/00 *Danner*, ECR 2002, p. I-8147, Para. 44., reiterated in Paragraphs 43 and 45, respectively, in C-422/01 *Skandia & Ramstedt*, ECR 2003, p. I-6817.

[49] It is worth mentioning the recent developments as follows:

- ECJ judgment of 5 May 2011 in C-267/09 Commission v Portugal (not yet published). Here, the ECJ declares that by adopting and maintaining in force Article 130 of the Personal Income Tax Code, which requires non-residents to appoint a tax representative in Portugal if they are in receipt of income requiring the submission of a tax return, the Portuguese Republic has failed to fulfil its obligations under Article 56 EC.

- ECJ judgment of 29 September 2011 in C-387/10 Commission v Austria (not yet published; available only in German and French). Here, Austria has infringed the freedom to provide services as provided for by the EEA agreement while introducing national laws, according to which it is only national credit institutions or trustees that are entitled to act as fiscal representatives in Austria upon the clearance of the proceeds arising from investment funds.

[50] Joined cases of C-155/08 *X* and C- 157/08 *Passenheim-van Schoot* ECR 2009, p. I-5093.

later *Persche*).[51] The relief at source procedure and the deprivation of foreign financial intermediaries and their clients of procedural rights in the source Member State do not seem to be consistent with this standard of effectiveness to be granted to taxpayers. Foreign resident citizens or companies may be mistreated in a host Member State where they are not granted effectiveness in law enforcement in the sense that national law practices omit to apply a positive standard. This means that national treatment should ensure fulfilment of Community freedoms.

Procedural rules must be assessed from the viewpoint of whether they constitute obstacles to the exercise of substantive freedoms. Procedural rules are thus not to be assessed taken by themselves, but to the extent that they may constitute barriers to the exercise of substantive law rights. Besides, the national public authorities, while exercising their power, are expected to be consistent with Community law in interpreting national law. If this is not the case, Community freedoms may be violated.

The question can also be raised of how to divide the burden of proof between the parties. Upon the finalisation of securities transactions, the question is: how much foreign financial intermediaries and domestic resident paying agents are obliged to provide relevant information. Also, how much the local tax authorities may be requested by national law to have recourse to the facilities of the EC Mutual Assistance Directive, and approach their foreign counterparts. Where domestic or foreign intermediaries suffer from the unusually high-level requirement of strict liability, for instance, upon the clearing and settlement of cross-border capital market transactions, no balance of interests can be achieved. Arguably, the national procedural law would be consistent with the proportionality principle only if foreign intermediaries and domestic ones with foreign clients were obliged to a "due care" standard like their normal domestic counterparts.

The Commission contends in *Persche* that, even if the EC Mutual Assistance Directive itself does not require a Member State to have recourse to the assistance of another Member State, the former State would however be required to have recourse to the possibilities offered by that Directive in order to exclude any less favourable treatment of cross-border situations as compared to purely internal situations.[52] Hence, the Directive itself does not require the national authorities to have recourse to the facilities the Directive provides. Such an obligation directly comes, however, from the principle of effectiveness as a positive standard. The requirements are thus relevant that the national authorities are obliged to follow a procedure in which it is possible to achieve the result envisaged by Community law, and that national law must be interpreted consistently with Community law.

In addition, the ECJ holds in *Persche* that a Member State cannot exclude the grant of tax advantages for gifts made to a body established and recognised as charitable in another Member State on the sole ground that, in relation to such bodies, the tax authorities of the former Member State are unable to check, on-the-spot, compliance

[51] C-106/89 *Marleasing*, ECR 1990, p. I-4135, Para. 8, reiterated in C-340/89 *Vlassopoulou*, ECR 1991, p. I-2357, see Paragraphs 17 and 22, and in C-168/95 *Arcaro*, ECR 1996, p. I-4705, Para. 41.

[52] See in the ECJ judgment of C-318/07, Para. 36.

with the requirements which their tax legislation imposes. An on-the-spot inspection is not usually required since the monitoring of compliance with the conditions imposed by the national legislation is carried out, generally, by checking the information provided by those bodies (Paragraphs 66-67). The national authorities that preclude the possibility of relief at source cannot thus justify this restriction by referring to the difficulties in organising on-the-spot audits if necessary because the organisation of such audits is always an extra burden for the authorities, no matter whether they have to conduct examination within the country or in another Member State.

## *Appendix 4 Adoption of a Harmonisation Directive*

To the extent that it is one of two implementation options, if a harmonisation Directive were to be adopted it could cover the following points:

1. E.U. financial institutions could be authorised to act as information and withholding agents by the E.U. Member States in which they are established ("Authorised Intermediaries" or "AI"s;
2. E.U. based Authorised Intermediaries[53] could be requested to report investor specific information via the tax authorities of the Member States in which they are established that would exchange the information with the relevant source and residence countries; and
3. submission of the Authorised Intermediaries to an audit or Agreed Upon Procecdure ("AUP") could be accomplished by the tax authorities of the E.U. Member State in which they are established; such audits or AUPs would be recognised by the source E.U. Member States.

### 4.1 Lessons from the harmonisation of financial law

#### 4.1.1 European passport in the financial sector

European rules guarantee both the freedom of establishment and the freedom to provide services. This allows citizens and their companies who wish to develop economic activities in another Member State to choose between doing so through a permanent establishment in the host country, or without a permanent establishment, rendering cross-border services from their home country. Since financial services constitute a highly regulated activity subject to rigorous supervision, it was necessary to create an organisation and procedures that guaranteed public control over supervised financial entities without restricting these fundamental freedoms. The technical instrument that made this possible was the "single passport" or "European passport" system.

One of the first places where the idea of the passport appears was in Council Directive 93/22/EEC on investment services in the securities field. As stated in the preamble of MiFID, the former Directive "sought to establish the conditions under which authorised investment firms and banks could provide specified services or establish branches in other Member States on the basis of home country authorisation and supervision". A similar figure appeared in the Consolidated Banking Directive.[54]

The basic idea behind the European passport is that, once an entity has obtained authorisation to carry out financial activities in one Member State, it does not need to obtain additional or supplementary authorisations in the host country. In order to operate the European passport system, it is essential to harmonise the requirements that must be fulfilled on a European level for administrative authorisation. It is also

[53] As introduced by Report by the pilot group on improving procedures for tax relief for cross-border investors, public discussion draft, Centre for Tax Policy and Administration, O.E.C.D, Paris, 2010.

[54] Directive of the Council and the European Parliament No. 2006/48/EC (as amended), OJ L 177, 30.06.06, p. 1.

necessary to allocate responsibilities among the relevant supervisors, which basically fall within the scope of home country supervisors, who should work in close collaboration.

The European passport has solved the problem of banking supervision when a financial entity develops activities in various jurisdictions, thanks to the cooperation between financial supervisors of different Member States, the exchange of information between them, and the establishment of guarantee mechanisms by virtue of which the host country supervisor can request actions or the intervention of the home country supervisor to correct any breach of financial rules, whether real or presumed. Financial supervision (including the supervision of banks, investment enterprises, insurance enterprises or collective investment vehicles) is a governmental activity. It entails the exercise of the relevant administrative authority, for which supervisors must have the power to require information and documentation, carry out their own verifications and impose penalties if necessary.

Obviously, these functions are subject to public law and remain therefore within State borders. National supervisors cannot exercise their powers beyond those borders unless and to the extent that the supervised financial entity agrees to it. Faced with this legal reality, legislators have two possible alternatives: to require global or complete supervision in each country or market in which the entity develops its activity or, on the contrary, to turn to the principle of cooperation between supervisors, in accordance with which only one of them could carry on supervisory activities. The second alternative was the one, which prevailed through the single European passport regime, under which it was decided that the home country supervisors would be in charge of basic control and supervision, aided by the host country supervisors, and information is transmitted accordingly.

### 4.1.2 Transfer of the European passport to the scope of fiscal law

Financial entities wishing to develop activities in another country without having a permanent establishment there would face a complicated obstacle. The host country tax authorities would require them to use a local intermediary whom they could hold responsible for all breaches of tax, formal or substantive obligations. By doing so, the Member State tax authorities are not trying to discriminate between financial entities acting in their market or much less to favour their national industry. They are simply trying to assure the effectiveness of the tax system by guaranteeing that any breach of tax rules can be effectively repaired so that taxes can be collected (it is another question that the appointment of a local representative must be in accordance with the proportionality principle as protected before the European Court of Justice).

If there were no local representative, the tax authorities could be powerless vis-à-vis a financial entity developing its activity in their market since, being established in a different jurisdiction, the host State would have no way to guarantee its compliance with its tax obligations. As in the case of the supervision of financial entities, tax collection is a public law activity and, as such, is subject to the limits of national sovereignty. As a result States cannot act coercively beyond their borders. Nonetheless, as we have seen in the financial field, the problem of national limits on supervisory activity has been resolved by attributing supervisory faculties to a single supervisor and by establishing mechanisms for collaboration and the exchange of information between the supervisory authorities.

Some of these components are already present in Community tax law. Tax rules currently exist which are based on the principle of cooperation between the tax authorities of the Member States, and which establish systems of the exchange of information (although this is not true in all cases) and mutual assistance in the collection of certain taxes (not all of them). It is no less true that, as opposed to financial regulations, European tax law is not harmonised to any significant degree. Hence, there continue to be great differences between tax obligations, both formal and substantive, in the different Member States.

Cooperation between supervisory authorities and the logic of the single passport are based on the harmonisation of substantive financial legislation. If such harmonisation does not take place beforehand, the collaboration between the supervisory authorities is still possible, but more complex. Notwithstanding the above, if there were an agreement in this sense between several, or all, European Member States, advances could be made on the road to cooperation between the competent tax authorities either through mechanisms of cooperation reinforced between States or even through European rules aimed at harmonisation. If this were the case, a financial entity wishing to develop its activity in another Member State would be subject to a regime similar to the financial passport. Registration with its national tax authorities would allow it to become a "collaborating entity" for the collection of the taxes derived from carrying on its economic activity in another Member State.

The following would be the pivotal points of the above system:

1. Only financial entities registered as such in one of the European Member States could be considered "collaborating entities" regarding the compliance of tax obligations arising in another State;
2. These collaborating entities should submit to examination by their home country tax authorities to verify that, when carrying on their activity, they have the adequate instruments, procedures and organisation to facilitate complete compliance with their own tax obligations as well as with those of their investors;
3. Depending on local legislation, the national authorities could choose between carrying out this verification themselves, or having it done by an external auditor empowered to develop this "supervisory" tax activity;
4. In case of entities wishing to carry on activities in different Member States, probably at least some of these control functions would inevitably be placed in the hands of private external auditors empowered to carry out this verification for the entity's account within the framework of a contractual agreement;
5. Classification as "collaborating entity" would not be definitive, but rather would be conditioned to the periodical control and supervision of these activities, for periods of no more than four years.

In practice, obtaining the status of a "collaborating entity" in one State, a financial entity would be allowed to render financial services in other Member State, including activities related to compliance with formal tax obligations (filing of tax returns, remittance of periodical information) and substantive ones (basically the application of withholdings and the payment of the amounts withheld to the host country authorities).

As a practical example, a financial entity can be mentioned that is domiciled in Spain and could act as representative of a group of Spanish investors who had acquired shares in a listed German company and a French one. The entity is authorised to render financial services, which include (and which both the home and host country

authorities are aware of) rendering financial services in France and in Germany, in both cases included in its programme of activities. At the same time it develops its strictly financial activity in the French and German markets, it would request the Spanish tax authorities to recognise its status as a "collaborating entity" with the tax authorities of Spain, France and Germany. The Spanish tax authorities would verify that, in effect, the entity has the organisation, systems and procedures to allow it to effectively comply with its tax obligations, both formal and substantive, and to facilitate the correct compliance of its clients'/investors' obligations. After verifying this point, and being granted the status of a "collaborating entity", the financial entity would start sending tax information to the Spanish tax authorities, so that they in turn could send it to their colleagues in Germany and in France. If it were considered necessary and appropriate, the entity could even apply the pertinent withholdings and pay them to the competent tax authorities. With regard to the exchange of information, the proposed system would not be very different from the one foreseen in Article 9 of the EC Taxation Savings Directive.[55]

Aside from this automatic exchange regime, other European rules have established mechanisms for the exchange of information between the Member States' tax authorities upon request in a specific case. This is the case of the mechanism foreseen in Article 2 of the EC Assistance Directive. That same Directive establishes the possibility that agents of the authorities of one Member State can be present in another Member State (Article 6).

There are other legal instruments of cooperation in tax matters between the States, such as, in the first place, VIES Regulation[56] and, in the second place, Council Regulation 2073/2004/EC of 16th November 2004 on administrative cooperation in the field of excise duties (as amended).[57] These Regulations provide a system of cooperation upon the receipt of a request for information, including the presence of agents of the other State's tax authorities in the offices of the host country's tax authorities and their participation in the administrative investigation. They even include the possibility of carrying out simultaneous controls in various States. The Regulations also include the exchange of information without a prior request through an automatic system of occasional or periodical exchanges of information.

Obviously, these are specific legal instruments, whose scope does not include tasks related to the tax compliance of investors operating through financial intermediaries (providers of investments services), not domiciled in the same State in which interest on their financial investments is paid. Nonetheless, the fact that these legal mechanisms of collaboration between the States in fiscal matters exist makes it possible to affirm that if a political agreement in this sense is reached between the States, there would be no major technical obstacles to developing a system of

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[55] Council Directive 2003/48/EC (as amended), OJ L 157, 26.06.03, p. 38. It is worth quoting this Article as follows:

"1. The competent authority of the Member State of the paying agent shall communicate the information referred to in Article 8 to the competent authority of the Member State of residence of the beneficial owner.

2. The communication of information shall be automatic and shall take place at least once a year, within six months following the end of the tax year of the Member State of the paying agent, for all interest payments made during that year."

[56] Council Regulation 1798/2003/EC, OJ L 264, 15.10.03, p. 1.

[57] OJ L 359, 04.12.04, p. 1.

cooperation that would make it possible to apply the E.U. passport regime for tax purposes based on cooperation between the States.

Consequently, it is important to highlight that the proposed model is not currently included in European regulations and the Member States are not legally obliged to act in this way. Nonetheless, it is no less true that the development of these instruments of fiscal cooperation between the States would render compatible the States' right to guarantee the collection of their taxes, with the need to advance in the construction of an authentic internal financial services market in which financial intermediaries could render all kinds of services to their clients in all E.U. Member States, including those related to compliance with their own formal and material tax obligations and with those of their clients.

#### 4.1.3 Use of private external auditors

The provision for private external auditors to verify the correct compliance of financial intermediaries' obligations in matters of organisation and internal procedures to assure the adequate compliance of their clients' tax obligations is commonplace in the various different systems of public-private cooperation in handling tax management related to financial investments (the US "Qualified Intermediary" is the best known case). Nonetheless, there are European countries in which such collaboration is not possible due to the existence of legal provisions, which define fiscal control as a public domain, which can only be exercised by the competent public authorities.

This is a political legislative decision of each State. So, it seems that, in principle, it would not be feasible to oblige a State to modify its legislation to alter this principle. Nonetheless, it is also true that establishing a control system of private external firms to which the States would delegate at least some of these tasks offers the clear advantage of its operability in different States, based on contractual agreements, which admit this possibility. In this sense, it may be advisable to bear in mind that the role of private firms in the field of financial control and supervision has been recognised for some time in various regulations of great relevance. So, there should be no major legal problems in extending it to tax matters.

An example of this can be found in the collaboration duties imposed on auditors in Article 53 of the Consolidated Banking Directive. However, the best example of the participation of private firms in the evaluation of private entities within the framework of financial supervision is the use of credit evaluations of external credit assessment institutions, in accordance with Articles 81 to 83 of the Directive which provides that they are eligible and their rating methodology is objective, independent, continuously under review and transparent, and that the resulting credit ratings are credible and transparent. Another facet of public law in which private firms (external consultants) frequently participate in the global process of supervision and control of organisations and internal procedures is found in matters of money laundering, in which the internal systems are subject to annual review by an independent expert.

### 4.2 Comments on the proposal for a Harmonisation Directive

#### 4.2.1 Extension of harmonisation to withholding taxation

It can be proposed in the context of the Consolidated Banking Directive and MiFID, that the single passport system introduced in the cross-border operation of financial

service-providers should be extended to the activity of these service-providers while administering as withholding agents the payment of tax and the related information on behalf of their clients in cross-border cases. Accordingly, financial service-providers could assume the function of a withholding agent in cross-border tax matters, while remaining under the supervision of the home tax authorities. This is not possible unless the Member States express their intention to extend the effective financial law harmonisation to tax matters. For the time being, such intention does not seem to exist.

#### 4.2.2 Cooperation in tax matters across the border

Although assistance in cross-border tax matters is quite comprehensive, thanks to the EC Mutual Assistance Directive and the EC Tax Collection Directive, the tax authorities of host Member States may not necessarily be satisfied by certain home Member States. Notably, the EC Savings Taxation Directive cannot be used as an analogy to the extent that under the Directive the home Member State relies on the information to be provided by the host Member State (the source country) while within the single licensing system of financial service-providers the host country authorities need to gain information from the home country authorities.

Cooperation in cross-border tax matters is an option for the affected authorities, not an obligation. The domestic tax authorities may well conclude in a specific case that it is not necessary to initiate mutual assistance with the tax authorities of another Member State. However, the domestic tax authorities must certainly not arrive at a final decision unless they make an assessment of the case under examination. Cooperation is thus subject to a case-by-case assessment in cross-border tax matters.

## *Appendix 5 Comparison of O.E.C.D IP and the E.U Recommendation*

### 5.1 Events Covered

| Commission Recommendation (high level) | O.E.C.D Implementation Package approach (detailed) | Points for consideration in relation to E.U. adoption |
|---|---|---|
| Dividends, interest or other income that securities may generate and that is subject to withholding tax in the source Member State (section 1.2. and 2(a) of the Recommendation) | Dividends and/or interest unless agreed otherwise between the AI and the Source Country (definition of Covered Payment in section III(I) of the Procedures).<br>It follows logically from the purpose of the AI system that the scope is limited to income from securities that is subject to withholding tax in the source country. | Scope of E.U./O.E.C.D proposals appear compatible |

### 5.2 Tax Relief Availability

| Commission Recommendation (high level) | O.E.C.D Implementation Package approach (detailed) | Points for consideration in relation to E.U. adoption |
|---|---|---|
| Treaty relief and domestic law exemptions (section 1.1. of the Recommendation) with the exception of relief pursuant to the parent-subsidiary directive or interest-royalties directive (section 1.3. of the Recommendation). | Treaty relief and domestic law exemptions with the exception of reduced rates or exemptions applicable to companies receiving dividends from companies in which they own a specified percentage of the capital or voting rights (Introduction to the IP and Paragraph 6 of the Agreement). | E.U. should consider modifying its proposed approach so that it encompasses:<br>• Non-E.U. resident investors entitled to tax relief under treaty or domestic tax law<br>• Source country residents entitled to tax relief under domestic law. |
| The relief is, in principle, limited to cross-border investors resident in the E.U. (section 1.1 of the Recommendation). | The relief is, in principle, available to all cross-border investors and source country residents. | Limiting the recommended relief system to investors that are resident in another E.U. Member State would result in the need to run two systems in parallel and increase costs for tax authorities, financial intermediaries and investors. |

### 5.3 Tax Relief Processes

| **Commission Recommendation (high level)** | **O.E.C.D Implementation Package approach (detailed)** | **Points for consideration in relation to E.U. adoption** |
|---|---|---|
| Relief at source as primary relief method. In exceptional cases, where relief at source is not feasible:<br><br>2. refund applications to the source country tax authorities (section 4 of the Recommendation ) or<br>3. requests for adjustments to the withholding agent (section 10.3 of the Recommendation) | Relief at source as primary method. In exceptional cases, where relief at source is not feasible:<br><br>1. applications for refund to the source country tax authorities by means of adjustment at the point of filing end year tax return or tax reclaim application (section VI(A)(3) and B of the Procedures); as well as<br>2. request for adjustments to the payor (section VI(A)(1) of the Procedures) | E.U. currently anticipates reporting of investor-specific information to the source country annually or upon request (see 4.14 below). It does not currently envisage the filing of an end year tax return and therefore there is no opportunity to adjust by means of such process, as anticipated by O.E.C.D. This process is beneficial to both financial intermediaries and tax authorities in that it allows for a prompt adjustment. The practical ability to make such adjustments may be further reduced in the event that the E.U. proposal is modified so as to allow reporting via the competent authority in the intermediary's country of operation, similar to the European Savings Directive (see below at 4.14). |

### 5.4 Withholding Responsibility

| **Commission Recommendation (high level)** | **O.E.C.D Implementation Package approach (detailed)** | **Points for consideration in relation to E.U. adoption** |
|---|---|---|
| Any financial intermediary in the custody chain satisfying the conditions at 4.12 below should have the possibility to be authorised to act as withholding agent subject to proportionate and non-discriminatory conditions | Any financial intermediary satisfying the conditions at 4.12 below can agree to assume primary withholding responsibilities (Section V of the application) | As noted at 4.12 below, E.U. arrangements are restricted to intermediaries established in E.U. member states or EFTA countries providing suitable administrative assistance. In practice, the system may have more flexibility if |

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| (section 5.1 and 6.1 of the Recommendation;).<br>The intermediary that is closest to the investor is considered to be best placed to act as withholding agent (section 5.1. of the Recommendation) | | intermediaries can opt whether or not they take on withholding responsibilities regardless of their relationship with the end investor. Any restriction may mean less intermediaries are willing to adopt this new system, which would result in duplicate systems. |

### 5.5 Adjustment of Initial Withholding

| **Commission Recommendation (high level)** | **O.E.C.D Implementation Package approach (detailed)** | **Points for consideration in relation to E.U. adoption** |
|---|---|---|
| See 4.6 above for over-withholding. | See 4.6 above for over-withholding.<br>Under-withholding is anticipated to be corrected by means of:<br>3. request for adjustment to the payor (section VI(A)(2) of the Procedures)<br>4. adjustment with source country tax authorities by means of end year tax return (section VI (B) of the Procedures) | See comments at 4.6 above. Further consideration is required with regard to corrections of under-withholding under E.U. Recommendation. |

### 5.6 Investor tax Documentation

| **Commission Recommendation (high level)** | **O.E.C.D Implementation Package approach (detailed)** | **Points for consideration in relation to E.U. adoption** |
|---|---|---|
| Source Member States are invited to allow alternative proofs of the investor's entitlement to relief to certificates of residence issued by the residence Member State. Those alternative proofs could include self- | Self-certification by the beneficial owner in the form of an Investor Self-Declaration ("ISD") which generally expires the last day of the fifth calendar year following the year in which the ISD is signed. No relief on the basis of KYC | KYC documentation should not be a substitute for ISD. It is important for investors and intermediaries to be able to use one single self-certificate under both E.U. and O.E.C.D systems. |

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|---|---|---|
| certification by the beneficial owner and KYC documentation (section 7.1 of the Recommendation). The Recommendation does not stipulate any renewal requirement for self-certifications. | documentation but obligation to review KYC documentation and other information available to determine whether the ISD is unreliable or incorrect (Section V(A)(1) of the Procedures) | |

## 5.7 Account Structure Requirements for Authorised Intermediaries

| **Commission Recommendation (high level)** | **O.E.C.D Implementation Package approach (detailed) ("IP")** | **Points for consideration in relation to E.U. adoption** |
|---|---|---|
| No specific account structure requirements imposed | No specific account structure requirements imposed. Section IV (C) of the Procedures, dealing with the form of tax rate information, anticipates the possibility of a financial intermediary operating a single omnibus account or separate omnibus accounts reflecting relevant withholding rates. | Both the Recommendation and the IP provide similar flexibility as to the account structure that can be used by financial intermediaries. At the same time there appears to be an increasing trend towards capital gains taxes levied at source, which might negate the more efficient account arrangements for withholding tax purposes envisaged by the E.U. and the O.E.C.D. The problems with such capital gains taxes and similar transaction based withholding taxes were described in both FISCO reports (see sections 2.3.1.2.1. and 2.3.1.3. of the first FISCO report and sections 2.4 and 2.5.3. of the second FISCO report). |

## 5.8 Information passed between intermediaries

| **Commission Recommendation (high level)** | **O.E.C.D Implementation Package approach (detailed)** | **Points for consideration in relation to E.U. adoption** |
|---|---|---|
| Financial intermediaries that have been authorised as "information agent" are | Financial intermediaries that have been authorised as AIs are allowed to pass pooled withholding tax rate | The IP is consistent with the E.U. Recommendation. The E.U. might wish to provide further |

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| allowed to pass pooled withholding tax rate information to the next information agent in the chain (section 5.2 of the Recommendation). | information to the upstream intermediary (section IV(A) of the Procedures). Further details in respect of the possible form of tax rate information are provided at section IV (C) of the Procedures. | information in terms of the means by which tax rate information may be passed (as noted by O.E.C.D at IV (C) of the Procedures) and emphasise that where withholding responsibility has been assumed, tax rate information (reflecting a zero rate) is still required to be passed, as noted by O.E.C.D at 6 (d) of Agreement. |

## 5.9 Eligibility and Authorisation of Authorised Intermediaries

| **Commission Recommendation (high level)** | **O.E.C.D Implementation Package approach (detailed)** | **Points for consideration in relation to E.U. adoption** |
|---|---|---|
| Eligibility criteria and conditions for authorisation by the Source Country tax authorities:<br>1. Member States are invited to develop common conditions and obligations governing the approval of financial intermediaries as information agent or withholding agent and such conditions should be proportionate and non-discriminatory (Sections 5.1 and 6.1 and 10.4 of the Recommendation);<br>2. Financial intermediary must be established in an E.U. Member State or in an EFTA member country that provides for a | Eligibility criteria and conditions for authorisation by the Source Country tax authorities (see Application for Authorisation to act as an Authorised Intermediary):<br>1. Financial intermediary must be resident in source country or in an eligible country as defined by the source country, taking into account factors including whether the source country has with that country or jurisdiction an effective exchange of information relationship, whether that country or jurisdiction has in effect adequate Know Your Customer Rules, whether the country or jurisdiction is a member of a multilateral organisation or community or grouping of countries that adopt common standards and | Both the Recommendation and the IP work on the basis of an authorisation by the Source Country tax authorities.<br><br>Another possible approach within the E.U. would be to allow authorisation by the competent authority in the intermediary's country of operation. However, such approach would require the adoption of a directive. Therefore, as a practical matter, it may be appropriate to temper this potential approach by adopting enhanced tax relief arrangements that can be implemented in the most expeditious manner. Unlike the IP, the E.U. arrangements are restricted to intermediaries established in E.U. member states or EFTA countries providing suitable administrative assistance. The T-BAG Group regards this limitation as too strict, although this might be a necessary restriction if the E.U. proposal were |

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| level of administrative assistance that is equivalent to that provided under relevant E.U. Directives (Recitals (9) and (10) and Section 1.2 of the Recommendation) . | approaches to issues of tax compliance, including mutual assistance (such as the Member States of the E.U. or O.E.C.D)<br>2. Financial intermediary must be subject to KYC rules<br>3. Financial intermediary must have the authority and adequate resources to perform the responsibilities of an AI<br>4. Financial intermediary must not be subject to legal or contractual prohibition to disclose account holder information as required by AI agreement. | modified to allow authorisation via the competent authority in the intermediary's country of operation. However, a dual system may possibly be envisaged whereby non E.U. / EFTA intermediaries would apply directly to the source country and E.U. /EFTA intermediaries would apply to the competent authority in the intermediary's country of operation.<br><br>The O.E.C.D leaves it to source countries to define eligible countries and the E.U. might wish to consider an expanded generic definition of eligible countries – e.g. O.E.C.D member states. |

## 5.10 Restrictions on Authorised Intermediaries

| **Commission Recommendation (high level)** | **O.E.C.D Implementation Package approach (detailed)** | **Points for consideration in relation to E.U. adoption** |
|---|---|---|
| No specific recommendations with respect to intermediaries that are not authorised as information agent or withholding agent | An intermediary that is not acting as an Authorised Intermediary can only obtain relief at source under the AI system provided that:<br>- it is subject to KYC rules and can thus be treated as a Contractual Intermediary (Section III (H) of the procedures);<br>- it passes on documentation and detailed payment allocation information from underlying intermediaries and investors (section IV(D)(2) of the Procedures). | The E.U. needs to elaborate on the handling of intermediaries that are not authorised as information agent or withholding agent and consider whether it wishes to mirror the O.E.C.D requirements.<br><br>The T-BAG Group considers that the O.E.C.D KYC requirement is a reasonable limitation. |

### 5.11 Reporting Requirements

| Commission Recommendation (high level) | O.E.C.D Implementation Package approach (detailed) | Points for consideration in relation to E.U. adoption |
|---|---|---|
| The information agent closest to the investor should report investor-specific information to the source Member State either on an annual basis or upon request (section 5.2 (b) of the Recommendation). | The AI is required to report to the Source Country detailed information regarding Reportable Payments paid during the calendar year in respect of assets held in an AI-designated account. Reportable Payments include payments made to other AIs, payments to accountholders that are resident in the Source Country and payments to accountholders that qualify for reduced rates or exemption of withholding tax. The accountholder information to be provided to the source country includes details of the income received, name and address of the beneficial owner, entity type, and, where the investor's residence country issues taxpayer identification numbers, that TIN, or such other identifying information as the residence country uses to identify individual taxpayers (see section VII of the Procedures). It is envisaged that this information will be transmitted electronically through a standard XML schema. The transmission method is currently still under consideration. | Financial intermediaries may prefer fixed annual reporting [filed within first six months of the following calendar year] in that it provides for a standardised approach and a check point to validate investor-specific information.<br><br>There is a clear benefit in harmonising the content, format and transmission method for reporting and it would be appropriate to encourage the E.U. to agree a common (or at least not incompatible) approach with O.E.C.D. In this connection, it should be noted that O.E.C.D reporting extends to source country residents.<br><br>It is understood that the E.U. has ordered a feasibility analysis on an alternative approach for routing the information from the AI to the source and residence country. Pursuant to this approach the AI would report the information to the tax authorities of its country of establishment, which would transfer the relevant information to source and residence country, Such an approach would require the adoption of a directive. Therefore, as a practical matter, it may be appropriate to temper this potential approach by |

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| | | adopting enhanced tax relief arrangements that can be implemented in the most expeditious manner. In addition such approach would only be available for E.U. based financial institutions. In absence of a legal basis, reporting by non E.U. financial institutions would still need to be done directly to the source country. The cost for tax administrations to administer both approaches in parallel may need to be taken into consideration. |

### 5.12 Exchange of Information

| **Commission Recommendation (high level)** | **O.E.C.D Implementation Package approach (detailed)** | **Points for consideration in relation to E.U. adoption** |
|---|---|---|
| Member States are invited to explore the scope offered by the recommendation for implementing new, non burdensome channels of information exchange aimed at providing both the source Member States and the residence Member States with investor specific information. This could be modelled on procedures drawn up under Community legislation, particularly Directive 2003/48/EC (section 10.2 of the Recommendation) | Information received by the source country from the AI is expected to be provided to the government of the investor's residence country through automatic exchange of information programs. Ideally, the latter country, to the extent it receives the information in a timely fashion would inform the source country reasonably soon thereafter if the investor who purports to be a resident thereof in fact is not. It is envisaged that the standard TRACE XML schema be used for exchanging the information and that Secure File Transfer (or the EU CCN system, where available) would be used for transmitting the information.. | See comments at 4.11 above. |

### 5.13 Compliance Review

| Commission Recommendation (high level) | O.E.C.D Implementation Package approach (detailed) | Points for consideration in relation to E.U. adoption |
|---|---|---|
| Procedures to investigate compliance could include single or joint audits by the tax authority of the source Member State, the tax authority of the Member State where the information or withholding agent is established or by external auditors (section 9 of the Recommendation) | The Competent Authority may require the delivery of an Independent Review but maintains the right to review directly the AI's compliance (Section VIII of the Procedures and annex 2 & 3 to the Procedures).<br>Frequency of Independent Review:<br>1. first full calendar year that the AI has in effect an agreement with any country pursuant to which it acts as an Authorised Intermediary;<br>2. thereafter, only upon request by any tax authority that is a Competent Authority under any such agreement & no more often than every third year unless a Competent Authority has good cause for requesting a more frequent Independent Review<br><br>Scope of Independent Review:<br>Review of the AI's compliance with its obligations in accordance with agreed procedures on the basis of a statistical sample of accounts. The review is principally concerned with the reconciliation of incoming/outgoing payments and the adequacy of investor documentation, withholding and reporting | There is a clear benefit in harmonizing compliance arrangements and it would be appropriate to encourage the E.U. to agree a common (or at least not incompatible) approach with O.E.C.D.<br><br>Where external audit is performed under the E.U. arrangements, this should be by reference to agreed upon procedures so that costs are proportionate to risks – i.e. it should not be necessary to receive an audit level of assurance. The E.U. may wish to consider whether an audit waiver is appropriate in certain circumstances – e.g. by reference to withholding amounts.<br><br>The E.U. anticipates possible review by the competent authority in the intermediary's country of operation. If agreed by all E.U. Member States, this should not, in itself, create compatibility issues with the O.E.C.D. From a business perspective, this would be the preferred long-term approach and would be consistent with MIFID. In addition, business believes that the review should extend to all source countries (E.U. or non E.U.). However, it is acknowledged that it may be difficult and time- |

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| | Scope of review by the Competent Authority: spot checks or a more expansive examination of the AI's operations and procedures. | consuming to provide a legal basis for such approach. Within the E.U. it would require the adoption of a directive. As a practical matter, it may be appropriate to temper this potential approach by adopting enhanced tax relief arrangements that can be implemented in the most expeditious manner |

### 5.14 Liability Standards

| **Commission Recommendation (high level)** | **O.E.C.D Implementation Package approach (detailed)** | **Points for consideration in relation to E.U. adoption** |
|---|---|---|
| No recommended liability standard | Strict liability for under-withholding if it relates to an investor who has an account directly with the AI or if the investor holds the securities through one or more intermediaries that are not AIs (Section II(B) of the Procedures). The IP Introduction sets out certain options for moderating the strict liability standard, however these are not binding on source countries. | Some moderation in E.U. requirements may be appropriate given MAD etc. |

### 5.15 Guidance

| Commission Recommendation (high level) | O.E.C.D Implementation Package approach (detailed) | Points for consideration in relation to E.U. adoption |
|---|---|---|
| No recommendations about guidance for intermediaries. | Source countries are recommended to provide guidance for the system to work predictably and efficiently: such guidance could relate to:<br>1. the treatment of specific entities for withholding tax purposes (such as pension funds, charities and CIVs);<br>2. any other areas identified as generating uncertainty with respect to the law or practice of the source country that are relevant to the operation of the AI system; | Detailed guidance from each source country will be essential, especially in the event that strict liability is adopted, Ideally such guidance should be provided in a standardised manner. |

## *Appendix 6 Commentary on Further Tax Related Issues*

Since the work of the T-BAG commenced a number of new tax measures impacting the post trading environment have been introduced.

The broad scope and narrow timelines required in which to implement some of the changes have proved particularly challenging for both business and Governments. T-BAG has not had time to consider these new tax measures specifically for this report. However it is clear further work will need to be undertaken if removal of the fiscal barriers affecting the post trade environment is to be fully accomplished.

Specifically on 14 February 2013 the European Commission adopted a proposal (Com/2013/71) for a Council Directive implementing enhanced cooperation in the area of financial transaction tax (FTT).

The proposals apply to both the resident and issuer, meaning the tax will be due if any party to the transaction is established in a participating Member State, regardless of where the transaction takes place.

The framework for the application of the FTT is likely to be quite complex for business and investors, in that the identification of the withholding and reporting entity is likely to depend on how and where the transaction is executed, the legal nature of the transaction (e.g., a securities transaction over a settlement system versus over the counter (OTC)), and the number of parties involved in the chain of the transaction.

We are aware of the work of the ECB on its TARGET2-Securities (T2S) project and are aware that T2S does not have any transaction tax functionalities or capabilities. As explained in the Third T2S Harmonisation Progress Report (published by the T2S Advisory Group on 13 March 2013), although the FTT will in principle concern the trading level, it is being investigated in the context of the T2S project whether the implementation of the FTT-related procedures may affect the settlement process, i.e. whether tax information needs to be communicated via settlement instructions or not.

A key attribute of legal certainty in the context of securities markets is that transacting parties have an unconditional obligation to settle transactions, otherwise “DvP” (delivery versus payment) transactions will be more likely to “fail”. This, too, could engender systemic risk. It would also not be helpful in an OTC context.

We anticipate that this will mean investors will have a significant level of uncertainty regarding liability to any subsequent assessment of tax, interest, and penalties and will lead to delays in agreeing trading terms between counterparties.

Ensuring there is consistency in implementation of the FTT will be vital to address some of these concerns.

Finally, in respect of the TARGET2-Securities (T2S) project, this project would also benefit from the harmonisation of withholding tax procedures across European countries, as highlighted in the three T2S Harmonisation Progress Reports published by the T2S Advisory

Group. (See http://www.ecb.europa.eu/paym/t2s/harmonisation/html/index.en.html). These reports highlighted that, as identified by the FISCO Expert Group, withholding tax relief at source is often reserved, under national tax, to local intermediaries. This means that remote access to the T2S system may be prevented, thereby disadvantaging foreign intermediaries, and potentially restricting the location of the issuer CSD to local CSDs.

As mentioned these areas require further review and discussion and T-BAG members would be happy to contribute further to any work in this and other areas affecting tax barriers in the EU.

## *Appendix 7 Member States Gap Analysis of Reclaims*

| | *AUS* | *FIN* | *BEL* | *BEL* | *DEN* | *FRA* | *GER* | *LUX* | *NED* | *POR* | *SPA* | *SWE* | *SWI* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | *Exempt* | *Treaty* | *Treaty* | *Treaty* | *Treaty* | | *Treaty* | *Treaty* | *Treaty* | *Treaty* | *Treaty* |
| *TIN* | *N* | *Y* | *Y* | *N* | *N* | *N* | *Y* | *N* | *Y* | *Y* | *N* | *N* | *Y (US)* |
| *ISIN* | *N* | *Y* | *N* | *N* | *N* | *N* | *N* | *N* | *N* | *Y* | *Y* | *N* | *N* |
| *Tax Year* | *Y* | *N* | *N* | *N* | *N* | *N* | *N* | *N* | *N* | *N* | *Y* | *Y* | *Y* |
| *Pay Rate* | *N* | *N* | *N* | *N* | *Y* | *Y* | *N* | *Y* | *N* | *N* | *N* | *Y* | *N* |
| *B.O Domicile* | *Y* | *Y* | *Y* | *N* | *N* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* |
| *B.O Type* | *Y* | *N* | *N* | *N* | *N* | *Y* | *N* | *N* | *Y* | *N* | *Y* | *Y* | *Y* |
| *Security Name* | *Y* | *Y* | *Y* | *N* | *Y* | *Y* | *Y* | *Y* | *Y* | *N* | *Y* | *Y* | *N* |
| *Nominal* | *Y* | *Y* | *Y* | *N* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* | *N* |
| *Pay Date* | *Y* | *Y* | *Y* | *N* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* | *N* |
| *Gross Amount* | *Y* | *Y* | *N* | *N* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* | *N* | *Y* | *Y* |
| *Tax Withheld* | *N* | *Y* | *N* | *N* | *N* | *N* | *Y* | *Y* | *Y* | *Y* | *N* | *Y* | *N* |
| *Reclaim Rate* | *Y* | *N* | *N* | *N* | *Y* | *N* | *N* | *N* | *N* | *N* | *Y* | *N* | *Y* |
| *Net Amount* | *N* | *N* | *Y* | *N* | *N* | *N* | *N* | *N* | *Y* | *N* | *N* | *N* | *N* |
| *Reclaim Amount* | *Y* | *Y* | *N* | *N* | *Y* | *N* | *Y* | *Y* | *Y* | *Y* | *N* | *Y* | *Y* |
| *Acquisition date* | *Y* | *N* | *N* | *N* | *N* | *N* | *N* | *N* | *N* | *N* | *N* | *N* | |
| *Lending/Hedging* | *N* | *N* | *N* | *N* | *N* | *N* | *N* | *N* | *Y* | *N* | *N* | *N* | |

| *Questions* | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *CIV breakdowns* | *Y* | *N* | *N* | *N* | *N* | *N* | *Y* | *N* | *N* | *N* | *N* | *N* | |
| *Filing Restrictions* | *N* | *N* | *A* | *A* | *B* | *C* | *N* | *D* | *N* | *Y* | *Y* | *N* | |
| *Dual Purpose (RAS & Reclaim)* | *N* | *Y* | *Reclaim* | *Reclaim* | *Reclaim* | *Y* | *N* | *N* | *N* | *Y* | *N* | *N* | |
| *Applicable to all income* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* | *Y* | |
| *Post reclaim questionnaire* | *Y* | *N* | *N* | *N* | *N* | *N* | *Y* | *N* | *Y* | *Y* | | *N* | |
| *PDF/online* | *Y* | *Y* | | | | | | | | | | | |

*Filing Restriction Notes: A -1 security per claim; B -9 securities per form; C- None, but claims can be filed annually; D -Only one claim per beneficial owner allowed twice per year*