EU Savings Directive: a cause for concern?

Eurobond and MTN issuers must be aware of some key issues in the latest proposals for an EU Savings Directive, says Stephen Reisbach of Clifford Chance.

In the February issue of *The Treasurer*, a note in the Technical Hotline (*Bond issuers beware*) outlined some of the concerns which Eurobond and medium term note (MTN) issuers would have to address in the light of the latest proposals for an EU Savings Directive.

This article looks at some of those concerns in more detail. Some of the problems identified in the earlier article have now been resolved, however, others have not and further possible difficulties have come to light.

Background

The current proposals for an EU Directive on the taxation of savings, as they apply to issues of debt securities, are:

- where a person in any EU Member State (whether the issuer or a paying or collecting agent) pays interest to an individual resident in another Member State, the tax authorities of the payer's Member State will be obliged to notify the tax authorities of the other Member State of the details of the payment. Payments of interest on securities issued by non-EU issuers (as well as EU issuers) will fall within the Directive if the payments are made through any person in the EU;
- however, three Member States (Austria, Belgium and Luxembourg) are to have the option, during a seven-year transitional period, of levying a withholding tax on such interest payments, rather than supplying information to the individual's tax authorities. The withholding tax will be 15% for the first three years and 20% for the remaining four. Seventy-five per cent of the tax will be paid over to the Member State where the individual is resident;
- eurobonds and other transferable debt securities will be excluded from the Directive if they were issued before 1 March 2001, or if a prospectus for the issue was 'certified by the competent authority' before that date. Nearly all listed debt issues require the issuer to 'gross up' payments of interest if a withholding tax is imposed, although the issuer is usually given the right to redeem the bonds early to avoid any adverse impact of grossing-up. This 'grandfathering' exclusion ensures that payments on bonds issued before 1 March 2001 can be made free of withholding (and therefore free of the attendant gross-up and tax call problems) even after the Directive comes into force; and
- the Directive is unlikely to come into force until 2003 at the earliest. Payments made before the Directive comes into force will not be affected.

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What are the issues for issuers?

There are a number of points which issuers will need to take into account when assessing the likely impact of the Directive on their bond issues.

The scope of the 'grandfathering' exclusion from the Directive

Eurobonds and other transferable debt securities will be excluded from the Directive if they were issued before 1 March 2001 or under a prospectus which was 'certified by the competent authority' before that date.

The first of these exclusions is tolerably clear. The second is less so. For issues listed on the London Stock Exchange, the requirement that the prospectus be 'certified by the competent authority' before 1 March 2001 may mean no more than that the prospectus was approved by the Financial Services Authority before that date. However, the position is not totally clear. Similar confusion may exist in other jurisdictions. No guidance has been forthcoming from the EU authorities on the point.

There is also a lack of clarity as to the scope of the grandfathering exclusion in the context of MTN programmes. In the UK, the effect of the approval of the 'base' prospectus for the programme is normally to grant authority for the listing of each separate issue made under the programme in the following 12 months. This arguably means that where the base prospectus was approved before 1 March 2001 any issues made in the 12 months following approval are grandfathered, even though they are made on or after 1 March 2001. However, it seems doubtful whether this was intended by the EU Council, and in the absence of further guidance it would not be safe for issuers to assume that such issues will be grandfathered. The Council probably intended to grandfather only standalone issues

where the prospectus was approved before 1 March 2001 but the issue itself took place after that date.

Fungible issues

A key concern has arisen over the effect of the grandfathering exclusion on securities which are issued on a fungible basis. Both governments and businesses frequently issue debt securities on terms which contemplate that subsequent issues may be made in the future on identical terms. The intention is that all the securities in each 'tranche' will be 'fungible', that is, they will trade interchangeably with one another.

Investors will be indifferent as to whether they hold bonds comprised in the original tranche or those comprised in subsequent tranches. Indeed, it will generally be impossible in practical terms to distinguish between the bonds in each tranche, all of which will be allocated the same ISIN or other securities identity number.

However, there may be a problem if the original tranche was issued before 1 March 2001, but there is an issue of a subsequent tranche or tranches on or after that date. The bonds comprised in the original tranche will not be within the scope of the Directive; however, bonds comprised in later tranches will be, and so may be subject to exchange of information or withholding tax requirements.

Accordingly, it cannot be said that the investor will be indifferent as to which securities they hold – a key test of fungibility. Furthermore, given the impossibility of distinguishing between the bonds in each tranche, the effect in practice could be that issuers or paying agents would withhold tax, or exchange information, on bonds comprised in the original 'grandfathered' tranche, as well as on those comprised in subsequent tranches, so that the supposedly grandfathered bonds would become 'tainted' by the issue of a new tranche on what was hoped to be a fungible basis.

This problem appears to have been identified only after the proposals were published. A working party of the Council has recommended that bonds issued after 1 March 2001 which are fungible with bonds outstanding on that date should have the benefit of grandfathering, provided that the new bonds are issued before 1 March 2002. This would give issuers another 12 months to come to terms with a threshold date over which fungible issues will not be possible.

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Gross-up provisions in bond documentation

What should issuers do to protect themselves against the possibility of a withholding tax being levied under the Directive on non-'grandfathered' bonds? Can they avoid a gross-up obligation?

The International Primary Market Association (IPMA) has, together with a number of major law firms, devised some standard wording to be included in gross-up clauses for non-'grandfathered' issues.

The IPMA wording proceeds on the basis that issuers should not be required to gross up payments where withholding tax comes to be levied as a result of the Directive. The Directive is intended to apply only to payments to individuals, but only a small minority of any bond issue is typically held directly by individual investors. It is not thought right that issuers should be subject to potential gross-up requirements because of the circumstances of a small minority of investors.

The IPMA wording is in two parts. The first simply excludes any gross-up obligation where payment is made to an individual and withholding results from the proposed Directive. The second is slightly wider and provides that there will be no gross-up obligation if withholding would have been avoided had the payment been made through another paying agent elsewhere in the EU. The effect should be that, even if the issuer appoints a paying agent in one of the three 'withholding tax' countries (typically Luxembourg), and that agent has to withhold, the issuer will not have any gross-up obligations if it also appoints a paying agent in at least one other EU country that does not impose withholding tax. The appointment of an additional paying agent should involve little or no additional cost to the issuer.

In many cases, the gross-up clause is fairly narrowly drawn, and the current proposals might not operate to impose a gross-up obligation on the issuer anyway. However, IPMA has suggested that the new wording should be inserted in the terms and conditions of all new bond issues.

This should protect issuers even if there are unusual gross-up provisions. Importantly, it represents a standardised approach which should eliminate grossing-up obligations without requiring the parties to investigate the circumstances of each case. The wording should be used by non-EU as well as EU issuers, if payments are to be made through any paying agent in the EU.

Responsibilities of paying agents

As from the time the Directive comes into force, EU paying agents will have new responsibilities, and paying agents may seek to reflect the cost of those additional responsibilities in the fees they charge to issuers.

The Directive will require paying agents to report information to their tax authorities (or levy withholding tax) where they make payment to an individual who is the beneficial owner of the interest and who is resident in an EU Member State other than that in which the paying agent is based. It is possible that in some cases the paying agent will be treated as making payment to an individual, even where the actual recipient is another person – perhaps, for example, where the payee is acting as a mere nominee for an individual.

Furthermore, the paying agent may not always simply be allowed to assume that the payee is the beneficial owner, if there are circumstances which put the paying agent on notice that someone else may be the beneficial owner.

As far as establishing the residence of the beneficial owner is concerned, the paying agent may have to obtain residence certificates or similar evidence. The requirements imposed by the Directive will also simply be *minimum* standards, and individual Member States will be free to supplement the basic rules.

In some EU jurisdictions, the result of all this may be that the responsibilities

of paying agents under the Directive will be considerably more extensive than they are at present. In the UK, agents should be less concerned about incurring significant additional responsibilities as a result of the Directive, since with effect from April 2001 UK paying agents are already subject to new information responsibilities under UK domestic law.

Under the new rules, paying agents are obliged to report to the UK Inland Revenue details of all interest payments on securities (UK or foreign, registered or bearer, listed or unlisted) which are made to individuals resident in the UK or certain other countries (these include, but are not limited to, all other Member States of the EU).

There is also no 'grandfathering' for securities issued before 1 March 2001 of the kind which will apply under the Directive.

UK paying agents should therefore already have 'absorbed' the additional responsibilities envisaged by the proposed Directive.

It is possible, given that no text of the Directive is yet available, that the responsibilities of paying agents under UK domestic law and the Directive will not be exactly the same. However, generally, UK paying agents should not be entitled to claim that the advent of the Directive will involve them in significant additional responsibility or cost, and issuers may look on such claims with some scepticism.

Issuers should be insulated from the responsibilities under the Directive to obtain and supply information to the tax authorities if all payments are made through paying agents, rather than by the issuer directly. Issuers should resist any attempt by paying agents either to pass back to the issuers the responsibility for obtaining the information about holders required by the Directive or to pass back any financial penalty incurred by the agent for not fulfilling its obligations under the Directive.

If a paying agent fails to report information, and is assessed to a penalty by the tax authorities, the paying agent should bear that penalty, since this results from its failure to fulfil one of its essential responsibilities under the normal paying agency agreement. Issuers should ensure that any such costs cannot be passed back to them (for example, under a widely-worded indemnity in favour of the paying agent).

There's still uncertainty

Even though the text of the proposed Directive is not yet available and further surprises may emerge, it is likely that most issuers will be able to limit or eliminate their potential exposure under the Directive by including exclusions from their gross-up obligations and ensuring that they appoint paying agents which can assume any reporting or withholding obligations under the Directive. However, issuers will need to take care that they do not accept responsibility for the paying agent's failings.

Furthermore, the continuing uncertainty over fungible issues will continue to cause some issuers commercial concern. ■

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A longer and more detailed report (which will incorporate any further changes in the rule that may occur during March 2001) can be found by visiting the Association's website at www.treasurers.org/thetreasurer/edit.html