Feature

KEY POINTS

- The prominence in the Financial Transactions Tax (FTT) regime of territoriality may be viewed as an inherent vulnerability which is out of step with some other forms of taxation.
- A notable feature of the FTT regime is the lack of exemptions in areas where they might commonly be found in a UK taxation context.
- The next step appears uncertain – with the UK stating publicly it does not support the FTT and adoption under the enhanced co-operation procedure remaining a possibility.

Authors Adam Blakemore and Oliver Iliffe

Proposals for a European Union Financial Transactions Tax

This article considers the mechanics of the proposed financial transaction tax (the FTT) and some of the challenges faced in creating a workable solution.

The proposals made by the EU Commission on 28 September 2011 regarding an EU directive on a common system of financial transaction taxation in the 27 member states of the EU have been debated widely since they were presented. The presentation of the proposed Directive (the Directive), together with proposals to amend Directive 2008/7/EC concerning indirect taxes on the raising of capital, represent the latest stage in a series of announcements by EU authorities directed towards ensuring that the European financial sector should "contribute more fairly" towards the costs of addressing and rectifying the current European financial crisis.

With the depth and nature of the European financial crisis continuing to evolve and the costs of stabilising and recapitalising the European financial sector showing no signs of abating, the Directive has come at a profoundly sensitive political and economic time. This article considers both the mechanics of the proposed financial transaction tax (the FTT) and some of the challenges which the EU Commission, member state governments and financial institutions will face in attempting to create a workable tax which achieves the aims of its proponents. The analysis in this memorandum is based on the Directive, and supporting documents, published on 28 September 2011.

WHAT IS THE SCOPE OF FTT?

Tax base

The FTT is a tax applied to financial transactions where at least one of the parties is a financial institution and either that party or another party to the financial transaction is established in a member state of the European Union. The terms "financial institution" and "financial transaction" are very broadly defined in the Directive.

"Financial institution" includes banks, credit institutions, insurance undertakings, pension funds, UCITS collective investment funds and their managers, securitisation special purpose vehicles (SPVs) and other special purpose vehicles such as group treasury companies. There are a limited number of institutions and entities which are excluded from being "financial institutions", such as central counterparties for clearing houses and securities depositories.

"Financial transaction" encompasses the sale and purchase of a "financial instrument" before netting or settlement (including repos and securities lending) and the "conclusion or modification" of derivatives agreements. The entry into a derivative, any change in its terms, any extension or close out of a derivative, whether cash or physically settled, would appear to fall within these concepts and therefore fall within the scope of FTT.

"Financial instruments" are themselves defined as being the instruments falling within Section C of Annex I of Directive 2004/39/EC (the Markets in Financial Instruments Directive). This definition encompasses a wide range of instruments covering shares, securities (including listed bonds), units or shares in collective investment undertakings, options, futures and other derivatives. Derivatives are included irrespective of whether they are physically or cash-settled and regardless of whether the underlying is itself a financial instrument. Both repos and securities lending agreements are expressly defined as "financial instruments", as are "structured products", the latter being securities or other financial instruments offered by way of securitisation or equivalent transactions involving the transfer of risk other than credit risk. The Explanatory Memorandum to the Directive makes it clear that the scope of FTT extends to regulated markets, multi-lateral trading facilities and also over-the-counter trading in financial instruments.

Importantly, a number of instruments and transactions are excluded from the scope of FTT. Loans, deposits, spot forex transactions, physical commodities and emissions credits are excluded from FTT. The EU Commission has also announced that "all transactions in which private individuals or SMEs were involved would fall outside the scope of the tax", although this exclusion does not prevent the economic costs of FTT being passed on to end-consumers.

Primary market transactions including the issuance, allotment and subscription of financial instruments are also excluded from the scope of FTT, "so as not to undermine the raising of capital by governments and companies". Controversially, however, the issue and redemption of shares and units in collective investment undertakings and alternative investment funds remain within the scope of FTT.

LIABILITY FOR FTT

FTT is payable by each financial institution (whether acting as agent or principal) which is a party to a financial transaction. Where a financial institution transacts with a non-financial institution counterparty established in a member state, the non-financial institution will be jointly and severally liable for the tax. FTT payable in respect of a financial transaction entered into by a bank branch in the EU will be paid to the member state in which the bank's head office is authorised or incorporated.

In circumstances where multiple parties are participating in a transaction, multiple FTT liabilities may arise. For example, where a financial institution acts as agent for a non-financial institution, both could be liable to FTT. Furthermore, transactions are individually subject to FTT. Where a single financial deal includes multiple, smaller, component transactions, each component transaction may be charged with FTT, even where the transactions are entered into between group members.

Rates and collection

FTT will be charged at two rates. While member states will be able to set their own rate, a minimum rate is proposed to be set at a level which achieves the "harmonisation objective" of the Directive while minimising the risk of delocalisation and attempting to avoid a negative impact on financial markets. Accordingly, a minimum rate of 0.1% is the rate of FTT generally charged on the purchase price or other consideration for a financial transaction. In the event that consideration is lower than market price or is the consideration for intra-group transactions, the taxable amount is to be the market price determined at arm's length at the date of the FTT charge. A lower minimum rate is to be imposed for derivatives at 0.01% of the notional amount at the time the derivative is purchased, sold, transferred, concluded or modified.

The time at which FTT is required to be paid to a tax authority of a member state will depend on the nature of the financial transaction. Where a transaction is carried out electronically, such as through a clearing system or on an exchange, FTT is payable "at the moment when the financial transaction occurs". FTT is payable on non-electronic transactions within three working days from the time the tax becomes chargeable.

Implementation

The proposal is for the FTT to be enabled by legislation in each of the member states by the end of 2013, with the tax taking effect from 1 January 2014.

The Directive is proposed under Art 113 of the EU Treaty, and would therefore require unanimous approval by each of the member states. In the event of any member state not adopting the Directive, it might be possible for the proposals to progress under an enhanced co-operation procedure under which one or more member states may be authorised to exercise EU non-exclusive competencies through various EU institutions with a view to protecting EU interests and propelling EU integration. However, it is uncertain whether the provisions of Art 20 of the Treaty of the European Union and Arts 326 and 327 of the Treaty on the Functioning of the European Union are capable of being satisfied in the particular circumstances of the FTT being introduced among only some, and not all, of the member states.

Withdrawal of other similar taxes

The introduction of the FTT would be matched by the withdrawal of other taxes on financial transactions across the EU. Although VAT and insurance premium tax would not be affected, existing taxes such as stamp duties and stamp taxation on securities would almost certainly need to be repealed. This would be welcomed by individual investors and certain funds which currently pay UK stamp duties or stamp taxation on the purchase of UK shares at a rate of 0.5% of the purchase consideration. Purchasers of UK shares and any securities which are subject to UK stamp taxes which are established outside the EU and which transact with non-EU persons outside the scope of FTT would be able to avoid both FTT and UK stamp taxation. However, these residual benefits have to be set against the prospect of some member states losing significant stamp taxation revenue.

WHAT ARE THE KEY ISSUES WITH FTT?

Territoriality

One of the key issues relating to the Directive is whether a financial institution will be treated as being within the scope of FTT. As currently drafted in the Directive, this happens when: (i) at least one party to the transaction is "established" in the member states; and (ii) a financial institution "established" in a member state is party to the transaction acting either for its own account or as an agent. A number of deeming provisions widen the scope of the second limb of the test. A financial institution is deemed to be "established" in a member state if the institution has (amongst other factors) its usual residence, permanent address, registered seat, or a branch in that member state in respect of transactions carried out by that branch.

A financial institution will also be deemed to be "established" in a member state if it is a party, whether acting as principal or as agent, to a financial transaction with another financial institution established in that member state, or is a party to a financial transaction with a counterparty established in that member state which is not a financial institution. The practical impact of this condition is to widen significantly the residence and location tests of "establishment", and thereby the scope of FTT. For example, a US bank (being a financial institution) entering into a financial transaction with an EU incorporated company (a non-financial institution) would be subject to FTT as regards that financial transaction. This would be the case even if the financial transaction is entered into by the US bank from New York. The US bank would be liable for any FTT due, with the EU corporate counterparty being jointly and severally liable.

One important exception to the "establishment" rule is that a financial institution will not be treated as being established in a member state where the person liable to pay FTT is able to show that there is "no link" between the economic substance of the transaction and the territory of any member state. The term "economic substance" is not defined. It will be interesting to see how and to what extent this provision is amplified or addressed in later versions of the Directive and supporting guidance.

Delocalisation

As noted by the EU Commission itself "[t]here are strong economic reasons for a high degree of harmonisation and co-ordination in order to avoid substitution and loopholes".

Modern financial transactions are extremely mobile; the EU Commission itself cites the Swedish financial transactions tax enacted in various forms between 1984 and 1991 as an example of the danger of unilateral introduction[1].

The territoriality of FTT may be construed as propelling market participants towards delocalisation and restructuring their activities on an entity by entity basis. For a non-EU financial institution, FTT could be mitigated through derivative contracts being effected outside the EU with non-EU counterparties. While the EU Commission has acknowledged this risk within Europe (hence the Commission's insistence that introduction should be across the 27 member states, including the UK), it is noteworthy that there is nothing in the EU Commission's proposals about the risk of financial activities migrating outside the EU.

For EU financial institutions, treasury subsidiaries and SPVs could be established in non-EU territories to prevent the contracting financial institution being subject to FTT. Additional analysis will be needed before such planning could be implemented, such as considering carefully the double tax treaty network of the jurisdiction in which the treasury subsidiary or SPV could be located, but the territoriality of the current drafting of the Directive does little to discourage such avoidance. While the Directive provides for the member states to adopt measures to "prevent tax evasion, avoidance and abuse", the prominence in the FTT regime of territoriality (as well as the identification of "instruments" and "transactions") may be viewed as an inherent vulnerability which is out of step with some other forms of taxation (such as services and supply-based taxes).

Given a global integrated financial system, it can be strongly argued that unless all key financial jurisdictions (including tax havens and low tax jurisdictions) are encompassed in an FTT, the risk of delocalisation may be insurmountable. Although the EU Commission accepts that introduction of FTT would come with the risk of "relocation or disappearance" of some transactions (such as high-frequency derivative transactions), the policy objectives behind FTT are unlikely to be achieved if the result of FTT introduction is a wider, systemic dislocation in European financial trading and banking markets.

Revenue raising?

The provenance of the FTT is readily apparent as being a tax arising from the financial crisis which is aimed at both disincentivising transactions which are perceived to pose a risk to market stability and also eliciting a degree of reparation from the European financial sector. The revenue estimates for the FTT are significant, being predicted as being in the region of €57bn per year shared between the member states. However, at a time when growth in many countries in the Eurozone is exceptionally low, economists have noted that the macroeconomic effect of the FTT, resulting in a "small, but non-trivial" reduction in economic output of between 0.53% and 1.76% in the member states, does nothing to help fragile economic recovery.

Moreover, estimates of revenue raised by the FTT appear to be predicated on an absence of widespread relocation of financial transactions to non-EU jurisdictions. The negative impact of the FTT, through an increase in the cost of capital as financial institutions attempt to pass FTT costs to clients, is unlikely to be welcome at a time when the European financial system is focused on liquidity provision, sustainable economic growth and bank recapitalisation.

Reducing "overly risky transactions and activities"

One of the anticipated benefits of the FTT is that the tax will "set incentives to reduce overly risky transactions and activities" and "curb speculation, noise trading and technical trade, and…decrease markets' volatility". While it is possible that automated high-frequency trading undertaken by EU entities and from EU permanent establishments may be driven out of the EU by the introduction of FTT, any reduction in systemic market and financial risk may be outweighed by other negative, behavioural consequences resulting from the tax.

For example, the definition of "financial transaction" would result in transfers of collateral falling within the scope of FTT, and being charged separately on each transfer at the higher rate of 0.1% applicable to securities. Consequently, and coupled with the exemption of lending transactions from the scope of FTT, the imposition of FTT on posting and transferring collateral would appear to encourage fewer collateralised lending transactions (for example, repos and stock loans) and an increase in uncollateralised lending. Such a development is unlikely to add materially to fiscal stability or creditor protection.

Even at the lower FTT rate applicable to derivative transactions, the EU Commission anticipates that between 70 and 90% of the EU derivatives market would be rendered uneconomical. Nevertheless, there is little suggestion in the EU Commission's publications relating to FTT that derivatives have a valid purpose to hedge and mitigate risk. The FTT would therefore penalise risk reduction instruments that aim to hedge market risk such as FX risk, interest rate risk or credit risk. By disincentivising such hedging instruments, there is a danger that the imposition of the FTT engenders, and does not reduce, systemic market risks.

As noted above, the possible incentives for financial institutions to undertake financial transactions outside the EU, in consequence of the territorial scope of FTT, also appear likely to encourage financing away from regulated, highly capitalised European institutions and markets towards less regulated, more thinly capitalised offshore financial centres to which derivative broker/dealers and other market participants may have migrated.

Combating such migration will be difficult. It is unrealistic to anticipate that offshore financial centres would, in the short term, willingly impose a financial transactions tax. Furthermore, it is difficult to discern a regulatory and policy approach within the FTT which is contiguous with other EU regulatory initiatives. For example, whereas regulatory initiatives such as the Solvency II Directive includes measures to determine whether non-EU insurer solvency regimes demonstrate sufficient equivalence to European regulatory requirements, the

Biog box
Adam Blakemore is a tax partner at Cadwalader, Wickersham & Taft LLP, London.
Email: adam.blakemore@cwt.com
Oliver Iliffe is a tax associate at Cadwalader, Wickersham & Taft LLP, London.
Email: oliver.iliffe@cwt.com

FTT may result in delocalisation of financial activities to less intensively regulated offshore jurisdictions where such equivalence may not yet have been established.

Absence of exemptions

Another notable feature of the FTT regime is the lack of exemptions in areas where they might commonly be found in a UK taxation context. Unlike with UK stamp taxation, there is no exemption for intra-group transactions. This is surprising as it is hard to envisage a situation where group companies could realise an overall "speculative" profit from round-tripping EU financial instruments or entering into intra-group derivative contracts that are fully hedged by external ones.

There is no general exemption for intermediaries. This could be interpreted as a symptom of a tax which is targeted at all levels of the market and not just the ultimate investor (in contrast to the regime of UK SDRT and stamp duty exemptions for intermediaries). However, the "cascading" effect of the FTT through a series of transactions would add materially to the impact of the FTT in a way which is not factored into the EU Commission's Impact Assessment of the tax. Unlike the proposed EU directive dealing with central clearing (EMIR), there is no exemption from FTT for transactions of corporate entities done for the purposes of hedging.

Furthermore, there are no exemptions for repos or securities lending (and indeed other collateral arrangements) where the purpose of the transfer of the financial instrument is an ancillary purpose of the main transaction. The absence is more surprising where the accounting of a repo is as a secured loan. A mortgage or charge of a financial instrument between members of the same group would also appear to be caught under the Directive, although it will be difficult in such circumstances to identify any taxable consideration for such a transaction.

CONCLUSION

Divisions have, perhaps unsurprisingly, emerged between the member states regarding the proposals for FTT. In early November 2011, the UK government publicly stated that it would only endorse an international version of FTT, and would not support an EU-wide introduction alone. This position was firmly articulated by the UK Chancellor of the Exchequer at the ECOFIN meeting on 8 November 2011, where reference was made to concerns over the mechanics of the FTT and its suitability in dealing with the objectives stated in the EU Commission's proposals.

It appeared for a short time that the proposed Directive might remain in limbo pending further discussions by the EU Commission and ECOFIN in 2012. However, a joint letter from the French President and German Chancellor to the European Council President on 7 December 2011 made clear reference to the creation of the FTT as one of the measures needed to achieve the greater convergence of economic policies among the 17 Eurozone member states. While the FTT was not mentioned in the communiqué of the European Council following the EU summit on 9 December 2011, the UK government's decision not to support the "new fiscal compact" among the other 26 member states leaves a European-wide introduction of FTT (at least in its current form) in further doubt. Recent statements by the UK Prime Minister on 8 January 2012 rejecting the FTT proposals unless introduced on a world-wide basis have reinforced the divisions between the member states on the topic.

The next step appears uncertain. Statements by the French Prime Minister on 9 January 2012 suggest that French legislation to impose a unilateral financial transactions tax may be presented as early as February 2012. Any attempt by a member state to unilaterally introduce the proposals for an FTT is, however, likely to face a number of legal hurdles. Legally, such a unilateral adoption would be questionable owing to the provision in Art 401 of the EU VAT Directive which prohibits member states from maintaining or introducing "turnover taxes". Whether the FTT is a "turnover tax" is not free from all doubt, and member states are likely to be wary of any unilateral introduction of any tax in a manner which might precipitate subsequent legal challenges.

It is also possible that the 17 Eurozone member states, or the member states except for the UK, may move to introduce the FTT under the enhanced co-operation procedure. However, such moves would be bound to raise questions about the possibility for the migration of financial transactions towards the City of London. For this reason, Denmark, Ireland, Italy and Luxembourg have all expressed reservations about a selective introduction of the FTT which does not encompass all the member states. A selective introduction of FTT may also be hard to justify under the legislative requirements of the enhanced co-operation procedure.

It is also possible that the proposals for the FTT might be overhauled radically. Possible changes may focus on the origin of financial instruments rather than the territory in which such instruments are to be transferred. Such changes would recast the FTT along the lines of a more familiar imposition such as the UK's stamp duty reserve tax, and may prove difficult to avoid where instruments are transferred electronically.

And it is possible that the FTT might be replaced altogether with an alternative method of imposing reparative liabilities on the European financial sector, such as some form of European bank levy or financial activities tax. In this context, the increase in the rate of the UK bank levy in the 29 November 2011 Autumn Statement announced by the Chancellor of the Exchequer might be construed as a careful move by the UK government to show that the raising of specific bank levies is a credible, non-FTT alternative to other methods of seeking contributions from the banking sector towards the costs of the financial crisis. ■

1 The Swedish tax on equity securities, fixed income securities and financial derivatives, imposed between 1984 and 1991, led to disappointing tax revenues, a fall in Swedish share prices and a very significant fall in market trading. During the first week of the tax, the volume of bond trading in Sweden fell by 85%. During the period of the tax, the volume of futures trading fell by 98% and the Swedish options trading market disappeared. ("Transaction Taxes and the Behaviour of the Swedish Stock Market", S Umlauf, *Journal of Financial Economics* 33, pp 227–240).