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The Proposals for a European Union Financial Transactions Tax

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 being presented. The proposed Directive represents 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 rectifying the current European financial crisis. With the depth and nature of the European financial crisis continuing to evolve, the Directive comes at a profoundly sensitive political and economic time.

What is the Financial Transaction Tax? ("FTT")

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 transaction" and "financial institution" are very broadly defined and encompass a very wide set of transactions in shares and securities (including listed bonds), including stock lending between a wide range of financial institutions, funds and SPVs. Importantly, collateral transfers as part of financing transactions and hedging would also be caught within the scope of FTT.

What are the key issues?

A financial institution will be treated as being within the FTT zone if it is "established" within the EU. In addition to "establishment" being judged by reference to incorporation, residence and regulation, an institution will also be "established" in the EU for the purposes of the FTT 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.
This casts the net of FTT very wide. For example, a US bank (being a financial institution) entering into a financial transaction with an EU incorporated company (a non-financial institution) would come within the charge 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 for the US bank's FTT liability (in addition to its own FTT liability on the transaction).

Uneconomical

The EU Commission has proposed that FTT will be charged at two rates. A basic tax rate of 0.1%. would be charged on the purchase price or other consideration for a financial transaction. A lower tax rate would be imposed for derivatives at 0.01% of the notional amount at the time the derivative is transferred, concluded or modified. Even at these low rates, the EU Commission anticipates that between 70 and 90% of the EU derivatives market would become uneconomical.

Impact for the Securities lending and Repo market

There is no suggestion that the FTT would be exempted where a financial transaction (such as the transfer of a listed security) is entered into merely to collateralise another transaction such as a securities loan. The imposition of FTT on posting and transferring collateral may lead to fewer collateralised lending transactions in the form of securities lending and repos and an increase in uncollateralised lending. Such a development would not enhance fiscal stability or creditor protection.

The territoriality of FTT may also propel market participants towards restructuring their activities on an entity-by-entity basis. For a non-EU financial institution, FTT could be mitigated through derivative contracts being entered into 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 all of the 27 EU Member States), there is nothing in the EU Commission's proposals about the risk of financial activities migrating to outside the EU towards less regulated, more thinly capitalized offshore financial centres.

What will happen next?

Sharp divisions have emerged between the Member States regarding whether the FTT should be introduced. On 8 November 2011, the UK government publically stated that it would only endorse an international version of FTT, and would not support an EU-wide introduction alone. This position as repeated by the UK Prime Minister as recently as 8 January 2012.

However, a joint letter from the French President and German Chancellor on 7 December 2011 made reference to the creation of the FTT amongst the 17 Eurozone Member States only. Statements by the French Prime Minister on 9 January 2012 suggest that French legislation to impose a unilateral French financial transactions tax may be presented as early as February 2012. It is therefore possible that all or some of the 17 Eurozone Member States may seek to create the FTT but without participation from the UK. Such a move would raise questions about the possibility for the migration of financial transactions towards the City of London.

It is also possible that the proposals for the FTT might be radically overhauled, perhaps with a view to re-casting it along the lines of a more familiar imposition such as the UK's stamp duty reserve tax. Alternatively, the FTT might be replaced altogether with an different method of imposing reparative liabilities on the European financial sector, such as some form of EU-wide banking levy.

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