Revised proposals for a European Union Financial Transactions Tax

Adam Blakemore analyses changes proposed by the European Commission within the Revised Directive on financial transaction tax and discusses the potential ramifications on transactions should they be introduced

This article considers the revised proposal made by the European Commission for a European Council Directive on financial transaction tax (the FTT) to be introduced under the EU's enhanced cooperation procedure by 11 participating member states: Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia (the FTT-zone).

This article focuses in particular on the changes proposed by the Commission in the Revised Directive (the Revised Directive) published on 14 February 2013 (ie when compared with the original Directive published in September 2011) and how these changes, and the Revised Directive in general, may affect transactions in the event that the Revised Directive is introduced in its proposed form.

Background

Following the publication of the initial proposals by the Commission for the FTT in September 2011, it proved impossible for unanimity to be achieved in an acceptable timeframe across all of the 27 member states. The lack of EU-wide support for the FTT led to an application by 11 member states to the Commission for the introduction of the FTT by means of the EU's rarely-used enhanced cooperation procedure. The draft decision by the European Commission in October 2012 to authorise enhanced cooperation with regard to the proposed Directive was approved by the European Parliament on 12 December 2012 and was endorsed by the European Council meeting on 22 January 2013,[1] albeit with abstentions from the UK, Luxembourg, Malta and the Czech Republic.

Timetable for implementation

The Revised Directive will now be subject to a period of consultation involving the Commission, the European Parliament, the European Economic and Social Committee and national parliaments in the participating member states. A first (or single) European Parliament Committee vote on the Revised Directive has been scheduled for 28 May 2013. Final wording for the Revised Directive will then be agreed among the participating member states, with a further opinion being sought from the European Parliament during the summer of 2013. A first reading plenary session in the European Parliament has been scheduled for 2 July 2013. At least nine member states will be required to vote on the final version of the Revised Directive, following which, if approved, national parliaments of the participating member states will be required to adopt the Revised Directive by 30 September 2013. The Commission's proposed timetable is for the FTT to be introduced from 1 January 2014. The mechanical stages necessary for the implementation of the Revised Directive are likely to constitute a challenging timeframe, not least because in a number of areas (particularly regarding the administration of the tax) the Revised Directive provides only the framework for the FTT, with detailed mechanics still to be determined by the participating member states.

Scope of the tax base

The Revised Directive is based closely on the scope and objectives of the original Directive published by the Commission in September 2011. A number of important additions and refinements address the implementation of the FTT across only 11 of the EU's 27 member states.

As in the original Directive, the FTT continues to apply 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 participating member state. Additionally, under the Revised Directive, FTT will also now be charged where a financial transaction is in respect of a financial instrument *issued* by an entity established in a participating member state (see 'Territoriality', below). The rates of charge of FTT, being a minimum rate of 0.1% on the purchase or other consideration for a financial transaction and a minimum rate of 0.01% of the notional amount for concluding or modifying derivatives, remain unchanged from the original Directive. The projected tax revenues from FTT have, however, been revised downwards in the Revised Directive to €31bn a year (from €57bn a year in the original Directive).

The terms 'financial institution' and 'financial transaction' remain broadly as defined in the Revised Directive, but have been subject to a number of refinements.

Financial institution

The definition of 'financial institution' continues to include banks, credit institutions, insurance undertakings, pension funds, UCITS collective investment funds and their managers, securitisation special purpose vehicles (SPVs) and others, such as group treasury companies. The Revised Directive now clarifies that other undertakings and persons will constitute a 'financial institution' where they carry on a specified activity and where the annual average value of financial transactions comprised in that activity is 'significant'.[2] The Revised Directive sets the threshold of what is 'significant' at 50% of the undertaking or person's overall average net turnover as derived from financial transactions. The specified activities for these purposes include both trading in financial instruments and the acquisition of holdings in undertakings. Group holding companies will therefore need to consider the enhanced definition with care, especially where they regularly acquire shares in subsidiaries and other financial instruments.

There are a limited number of institutions and entities which are excluded from being 'financial institutions'. This number is increased in the Revised Directive to include member states and other public bodies engaged in managing public debt. Transactions with the European Central Bank, the European Financial Stability Facility, the European Stability Mechanism and central banks of member states (but not central banks of non-participating member states) are also excluded from the scope of FTT. Exclusions from the primary charge to FTT for central counterparties, international central securities depositaries and central securities depositories continue to be included in the Revised Directive provided that their activities do not consist of financial trading. In a clarification from the original Directive, such counterparties and depositaries may, however, be subject to a secondary liability for FTT in the event that the person primarily liable to pay the tax fails to do so.

However, there remains no general FTT exemption for financial institutions acting as intermediaries, brokers or market-makers (see below: 'Absence of key exemptions').

Financial transaction

'Financial transaction' includes the sale and purchase of a financial instrument before netting or settlement, the 'conclusion and modification' of derivatives agreements (whether or not the derivative's subject matter is an underlying financial instrument), repos and stock-lending transactions, and certain intra-group transactions in which the economic terms include a transfer of risk associated with a financial instrument but which fall short of a purchase or sale. The definition of 'financial instrument' remains the same as in the original Directive and therefore continues to include transferable securities (such as shares and bonds), structured securitisation products, units or shares in collective investment undertakings, options, futures and other derivatives.

The Revised Directive now clarifies that the exchange of two financial instruments produces two transactions (a purchase and a sale) rather than one. By contrast, repurchase agreements, reverse repurchase agreements, and securities lending and borrowing agreements are treated as a single financial transaction. This is a partial relaxation of the treatment of repos and stock lending in the original Directive, which appears to acknowledge the essential lending nature of repos and stock lending transactions.[3] There is, however, no exemption in the Revised Directive for non-cash collateral transfers supporting repos and stock lending. This seems surprising given the general relaxation of the rules as regards repos and stock lending and the stated policy objectives of the FTT as targeting 'transactions which do not enhance the efficiency of financial markets'.[4]

Another notable amendment concerns the meaning of a 'modification' of a derivative. In the original Directive, 'financial transaction' included the 'conclusion or modification' of derivatives agreements, resulting in the entry into a derivative, any change in its terms, any extension or close out of a derivative, whether cash or physically settled, falling within the scope of FTT. The provision is now clarified so that each 'material' modification of a derivative will constitute a financial transaction. A modification is now considered to be 'material' where, in particular, it involves a substitution of at least one party, where the consideration is subject to alteration, and also (less precisely) 'where the original operation would have attracted a higher level tax had it been concluded as modified'.[5] Notably, the Revised Directive makes it clear that 'material modification' now results in not only a potentially taxable event for derivatives, but also for all types of 'financial transaction'.

Transactions excluded from FTT

The original Directive contained exclusions for certain transactions. These exclusions remain in the Revised Directive and include provisions excluding the FTT from liability on credit and loan transactions, primary market issuance, spot forex currency transactions (although not forex derivatives), physical commodity trades and emissions credits. Insurance contracts created under English law should fall outside the FTT. Underwriting of shares as part of a capital issuance is also excluded from the FTT. Most consumer-level financial products are intended to fall outside the tax (such as mortgages and consumer credit), although some products, such as life assurance, are not excluded expressly and might therefore fall within the scope of charge in certain circumstances.

The Revised Directive clarifies that the exclusion for primary market issuance now extends to the issuance of shares and units in UCITS and alternative investment funds (AIFs), as well as the issue of shares and securities. The rationale for this change is stated by the Commission as being to 'preserve fiscal neutrality across products', associating the issuance of a share or unit in UCITS or AIFs with non-taxable capital raising.[6] It is also possible to interpret the clarification as a grudging acceptance by the Commission that the provisions of the Capital Duties Directive would have, in any event, made an imposition of the FTT on the issuance of shares and units in UCITS and AIFs an infringement of Community law.[7] Less helpfully, the redemption of shares and units remains within the scope of FTT (being 'not in the nature of a primary market transaction').[8]

A new exclusion has also been added in Article 3(4)(g) of the Revised Directive, excluding transactions carried out as part of 'restructuring operations' under Article 4 of the Capital Duties Directive. The new exclusion falls well short of a broad intra-group transfer exemption, with 'restructuring operations' being broadly analogous to reorganisations and reconstructions for UK tax purposes (see 'Absence of key exemptions' below).

Territoriality

One of the key issues in the original Directive from September 2011 was the territorial scope of FTT. This theme continues to be critical in the Revised Directive. Given the circumstances of the proposed introduction of FTT through enhanced cooperation, a number of changes have been introduced in the Revised Directive to prevent avoidance of FTT through the 'intrinsic risk'[9] of relocation of financial activity from the participating member states.

Changes to definition of 'establishment'

Under the Revised Directive, FTT will be charged on a financial transaction where two conditions are met:

(a) at least one party (whether or not a financial institution) to that financial transaction is 'established' in a participating member state; *and*

(b) a financial institution (either acting for its own account or the account of another person, or is acting in the name of a party to the financial transaction) 'established' in a participating member state is a party to that financial transaction.

The identification of when a financial institution is 'established' in a participating member state has been extended in the Revised Directive. As before, a financial institution is deemed to be 'established' in a member state if the financial 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 (non-financial institution) counterparty established in that member state.[10] While this provision has not been changed in the Revised Directive, the impact is likely to be more pronounced now that the FTT is to be implemented across only part of the Single Market.

Branches of a financial institution established in a participating member state will be subject to the tax even where not located in an FTT-zone country. Transactions cleared through a clearing system in a participating member state, such as Euroclear, may also be subject to FTT even where *all* the transaction parties and the underlying issuer are not established in the FTT-zone.

An exemption from FTT is available where a financial institution can demonstrate that there is no link between the 'economic substance' of the financial transaction and the territory of any participating member state. In this situation, the entity will not be deemed to be established in any participating member state. 'Economic substance' is not defined in the Revised Directive but might reasonably be construed as extending to the assets, liabilities, cash-flows or business results in the participating member state that affect the transaction. It is unfortunate that no detail is given of the meaning of 'economic substance' in this context as other territorial changes in the scope of the tax (considered in the following paragraph) potentially elevate the importance of this exemption significantly.

The Revised Directive has extended the territorial scope of the tax with two important changes:

(i) A financial institution will be deemed to be established in the territory of a participating member state where it is authorised or entitled to operate in a participating member state through a regulatory 'passport'[11] while having its headquarters in a non-participating member state. The impact is clearly intended to extend to financial institutions in non-participating member states, as well as non-EU third countries. For example, where a passported UK financial institution, entitled to operate in Italy, enters a financial transaction with an Italian branch of a Dutch bank would result in both the UK and

Dutch financial institution being deemed to be 'established' for FTT purposes in Italy. Both would pay FTT to the Italian tax authorities at the FTT rate established in Italy.

(ii) The taxation of financial institutions 'established' in a participating member state is supplemented by taxation of financial instruments on an 'issuance principle', intended as a 'last resort' determination of where a financial institution is deemed to be established.

The issuance principle applies where:

(a) none of the parties to the financial transaction is established in a member state and where at least one party is a financial institution;
(b) none of the parties operate from outside the participating member state through a regulatory passport;
(c) the financial transaction involves a financial instrument 'issued' within a participating member state; and
(d) where there is (broadly) a link between the economic substance of the financial instruments in the financial transaction and the territory of the participating member state. A financial instrument is treated as being 'issued' by a person who has a registered seat or (for a natural person) a permanent address or residence in the participating member state in question.[12]

The application of the 'issuance principle' deems a financial institution to be 'established' in the participating member state from which the financial instrument in question is 'issued'. For these purposes, the financial instrument being 'issued' will constitute shares, bonds, money market instruments, structured products, units and shares in collective investment undertakings and derivatives traded on organised trade venues and platforms. OTC derivatives traded *outside* of an organised platform will not fall within the scope of the FTT charge on the basis of the 'issuance principle'.[13]

Both the passporting extension to the definition of 'establishment' and the 'issuance principle' are designed to bring financial transactions into the charge to FTT in certain circumstances where the parties are outside the participating member state or outside the EU.[14] For example, a US bank selling shares in a German company (or, perhaps, ADRs in that company – see 'Depositary receipts' below) to another US bank, with neither US bank being otherwise 'established' in Germany, will result in both US banks being liable for FTT under the issuance principle.

FTT liability, collection and administration

The Revised Directive does not specify the details of FTT collection and administration, but 'only sets out the basic rules and framework' for such rules.[15] The charging and collection framework is essentially unchanged in the Revised Directive. FTT is payable by each financial institution (whether acting as agent or principal) which is a party to a financial transaction.[16] Financial institutions remain chargeable when transacting on their own account or where acting for the account of another person, except where that other person is a financial institution.

FTT is payable to the tax authority of the participating member state in whose territory the financial institution is established. Where the 'issuance principle' applies, a financial institution outside the FTT-zone is required to pay FTT in respect of a financial transaction to the tax authorities of the participating member state where the financial instrument in that transaction has been 'issued'. Detailed provisions regarding how FTT liabilities under the issuance principle will be enforced, particularly where all transaction parties are physically located outside the FTT-zone and where transactions have been cleared on a non-FTT-zone platform, have been left to each participating member state to implement.[17] Financial institutions are, however, likely to be required to pay at least some FTT to tax authorities in participating member state where the institution is not physically located.

In the event that FTT is not paid on time, all other parties to the transaction (including non-financial institutions) are jointly and severally liable for the payment of the tax. Member states will be permitted, through their national tax collection systems, to provide that other persons (including advisors and intermediaries) can be jointly and severally liable for payment of FTT.[18] This provision is likely to enable a participating member state to collect secondary tax liabilities from transaction parties and other persons resident in that member state, in preference to attempting to collect FTT from a financial institution outside the FTT-zone.

The Revised Directive contemplates exchanges, organised trade venues and platforms, central clearing counterparties and central securities depositaries playing a key part in the collection of FTT. While central counterparties and central securities depositaries (among others) are exempt from primary liability under FTT, they can be secondarily liable for the tax. Indeed, the Impact Assessment accompanying the Revised Directive notes that where OTC transactions are cleared and settled through a clearing house, tax collected through this method would be a 'cost effective solution'.[19] Central counterparties are likely to address the risk of secondary liabilities in these circumstances through indemnity protection and the revision of standard terms.

In conjunction with the expansion of the scope of persons potentially liable for FTT, the Revised Directive has permitted the expansion of the reporting framework of the tax. Participating member states will be required to adopt measures to ensure that every person liable for FTT reports a monthly information return including all information relevant to the calculation of FTT. The current provisions of MiFID and the EMIR are likely to be used to facilitate the monitoring of FTT collection and compliance[20], complementing the imposition of FTT on a joint and several liability basis.[21] The reporting measures are intended to extend to financial institutions which do not have a base of operations within the participating member state. The Impact Assessment also sets out a number of situations in which OTC derivative reporting obligations on central counterparties and other counterparties under EMIR could be accessed by the tax authorities of the participating member states under national law.[22] FTT audits and dedicated IT procedures 'developed possibly on an EU-wide basis or with knowledge sharing between member states' are also contemplated. The issues raised by this framework raises questions of confidentiality and the protection of other EU rights of market participants.

Anti-abuse rule

The Revised Directive also contains a new provision introducing a 'general anti-abuse rule' (the AAR). The AAR establishes that any 'artificial arrangement or an artificial series of arrangements which has been put in place for the essential purpose of avoiding taxation and which leads to a tax benefit shall be ignored'.[23] The AAR is based on the framework provisions set out in the European Commission's Recommendation of 6 December 2012 on aggressive tax planning (the Recommendation). The AAR also attempts to place on a statutory basis the ECJ's case law on abuse of rights in the context of VAT, although it remains to be seen how enthusiastic the ECJ will be to transpose VAT principles from cases such as *Halifax*[24] and *Part Service*[25] across to the FTT. Participating member states are required to consider such artificial arrangements for tax purposes by reference to their 'economic substance'. The 'purpose' in the context of this rule consists of avoiding taxation 'where, regardless of the subjective intentions of the taxpayer, it defeats the object, spirit and purpose of the tax provisions which would otherwise apply'. A purpose is an 'essential purpose' where any other purpose 'appears at most negligible, in view of all of the circumstances of the case', potentially replicating the 'essential aim' test in VAT abuse of rights cases such as *Part Service*. In determining whether an arrangement or series of arrangements has led to a tax benefit, participating member state are required to compare the FTT due from the taxpayer under the arrangements with the tax which would have been owed in the absence of the arrangements.

There is little elaboration of the practical impact of the AAR provisions in the preamble to the Revised Directive, or in any of the Commission's supporting documents published at the same time as the Revised Directive. The suggested approach in the Recommendation that a tax benefit may arise where 'an amount is not included in the tax base, a tax payer benefits from a tax deduction, a loss for tax purposes is incurred, no withholding tax is due and foreign tax is offset', is unlikely to resolve concerns.[26] Several of these example tax benefits have no application to FTT. References to the 'object, spirit and purpose' of the FTT provisions are likely to be highly controversial (in addition to being somewhat subjective and elastic terms in their own right).[27]

Perhaps most surprisingly, in contrast to the long discussion and consultation process surrounding the forthcoming introduction of a 'general anti-abuse rule' in UK Finance Bill 2013, there seems to have been little discussion with Europe's financial institutions or representative bodies regarding the Commission's proposal for codification of the AAR in the Revised Directive. The inevitable discussions about the application of the AAR will now need to take place in the already challenging timeframe for introduction of the FTT with an additional risk that implementation of the AAR into national legislation could lead to differences between the participating member states' domestic provisions.

The Revised Directive also includes a new provision focusing on abuse in the case of depositary receipts and other similar security wrappers. The provisions relating to depository receipts incorporate elements from the AAR, perhaps most importantly the meaning of an arrangement's 'essential purpose'. A depositary receipt issued with the 'essential purpose' of avoiding tax on transactions in the underlying security issued in a participating member state, and where all other purposes are 'negligible', will itself be deemed to have been issued in that member state in the event that a tax benefit arises. The Commission's intention appears to be to counteract the potential use of depositary receipts to circumvent transactions in underlying securities which fall within the 'issuance principle'. Only where the taxpayer liable for FTT can demonstrate that the depositary receipt was not issued with the 'essential purpose' of avoiding FTT, and presumably would have been issued in any event absent tax considerations, would FTT not be charged.

No grandfathering of this specific avoidance rule regarding depository receipts already issued and in existence before 1 January 2014 has been announced at the date of this article. Where depository receipts issued outside of a participating member state, such as American depositary receipts (ADRs), have been issued for shares issued by FTT-zone established companies over a period of time prior to the introduction of the FTT, it would seem to be difficult to argue by reference to a course of capital raising that the 'essential purpose' for the issue of depository receipts could have been to avoid FTT. The commercial reasons for issuing ADRs in such circumstances, including US dollar settlement and payment flows, might well be more than 'negligible' in these circumstances.

More difficult questions are likely to arise, however, where depositary receipts are issued after the introduction of the FTT where any party's main (but not sole) intention in purchasing ADRs in FTT-zone shares is to benefit from the lower cost component of those ADRs when compared with the underlying securities issued in a participating member state.

Other key themes of the FTT

Despite the statement by Algirdas Šemeta, the EC Commissioner responsible for taxation, that 'what we have proposed is an unquestionably fair, technically sound and legally robust tax',[28] concerns remain regarding the impact of FTT in the context of European finance and its compatibility with Community law.

Absence of key exemptions

The FTT regime in the Revised Directive continues to lack exemptions from liability in areas where they might commonly be found in a national taxation context. No general exemption exists for intermediaries or market makers (such as exist in UK stamp duty and SDRT, for example). This is likely to result in a 'cascade' of FTT charges on multiple market participants in a single economic transaction, thereby significantly increasing the FTT liability for even straightforward on-exchange transactions.

While an exemption exists for a financial institution acting in the name of another financial institution (in which case the principal financial institution is liable to pay the FTT due)[29] this exemption will not prevent 'cascade' charges being imposed on intermediaries such as brokers, financial intermediaries or central clearing counterparties in the settlement of on-exchange derivatives or OTC derivatives subject to central counterparty clearing. Structures utilising a number of different entities and transactions to create and return value to investors, such as where funds established as open-ended investment companies are selling securities, will also be vulnerable to multiple FTT charges through 'cascades'. Any increased tax liabilities are likely to be passed on to the end consumer owing to the low margins being taken by multiple intermediaries in the same economic transaction.

There continues to be no general exemption available for intra-group transactions. The introduction of an exemption for 'restructuring operations' under Article 4 of the Capital Duties Directive (CDD) is likely to be of only limited effect to many financial groups.[30]

Despite active lobbying, and considerable pressure by certain national governments (principally The Netherlands), pension funds remain subject to the FTT as 'financial institutions'.

Legal challenges to implementation

The Commission published a proposal for a Council Decision on 23 October 2012 confirming that the rights, competences and obligations of non-participating member states would be fully respected with enhanced cooperation on FTT.[31] The main justification for the FTT advanced by the Commission was that an FTT introduced under the enhanced cooperation procedure would reinforce the Single Market, by reducing the complexities and competitive distortions that arise from a patchwork of different national approaches to financial transaction taxes.[32]

While the Commission's proposal was unequivocally supportive of the enhanced cooperation proposal, it seems likely that concerns regarding the compatibility of the enhanced cooperation in the area of the FTT under Community law will surface in the coming months. Article 20 of the Treaty of the European Union (TEU) provides for the enhanced cooperation between member states where unanimity is not possible. Under the terms of Article 20, enhanced cooperation shall 'aim to fulfill the objectives of the Union, protect its interests and reinforce the integration process'. The provisions of Articles 326 and 327 of the Treaty on the Functioning of the European Union (TFEU) provide further requirements for enhanced cooperation, ensuring that the cooperation 'shall not undermine the internal market or economic, social and territorial cohesion'. The cooperation must not distort competition, constitute discrimination and should respect the competencies, rights and obligations of non-participating member states.

It remains uncertain whether the provisions of Article 20 TEU and Articles 326 and 327 TFEU are all capable of being fully satisfied in the particular circumstances of the FTT being introduced among only some, and not all, of the member states. An implementation by the participating member state of the Revised Directive would at least have the potential to create distortion of competition between member states. This can be evidenced, for example, through the differing treatment of a third-country non-EU financial institution transacting with either a UK bank or a bank in one of the participating member states. Assuming the issuance principle did not apply to the transaction, the UK bank would be in a better competitive position than the FTT-zone bank.

It is also difficult to see how the competencies and rights of a UK financial institution are respected where it is subject to both UK stamp duty on the purchase of UK shares from a German bank and also subject to FTT (in Germany) on that same purchase. It is difficult to see how the UK financial institution would not be discriminated against in this situation (Article 326 TFEU), nor how the rights of that UK financial institution would have been respected under enhanced cooperation (Article 327 TFEU).

It is possible that a single (or group of) non-participating member states could bring an action against the legal validity of the introduction of FTT though enhanced cooperation, although the legal mechanics of mounting such a challenge are not straightforward. (The complicated political dynamics which would be associated with a non-participating member state making such a challenge are also not inconsiderable). A challenge by a number of financial institutions remains a possibility, perhaps in particular those institutions which are established in a non-participating member state and which would be subject to continuing national financial transaction taxation in addition to suffering FTT liabilities on their financial transactions.

Market responses to the Revised Directive

While the consequences of the implementation of the FTT through enhanced cooperation are far from certain,[33] it is possible to anticipate a number of potential market responses.

(i) Relocation and displacement

The Commission's stated view is that 'relocation is a very unlikely response' to FTT introduction.[34] The design of the Revised Directive is intended to ensure that a financial institution would have to geographically relocate, abandon trade on organised platforms in the participating member state, avoid transacting with other financial institutions in the FTT-zone and avoid transacting in securities FTT-zone issued financial instruments to be confident of avoiding FTT.

The interconnected nature of the financial markets, particularly in Europe, makes it difficult for this degree of displacement to be achieved. Any notions of simply migrating existing European financial operations to a geographical location outside the participating member states is unlikely to be effective by itself in avoiding FTT. Accordingly, while the geographical scope of FTT has been narrowed to (at present) only 11 participating member states, the territoriality of the FTT and the design of the tax has the potential to affect numerous transactions entered into by financial institutions and other entities physically located outside the FTT-zone.

Furthermore, owing to the territorial scope of FTT any incentivisation for financial institutions to relocate financial transactions outside the EU is unlikely to be universally beneficial. Such incentivisation could result in financing migrating 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 relocated.

Nevertheless, the continued conjunction of residency requirements in the determination of 'establishment' and the introduction of the 'issuance principle' is unlikely, it is submitted, to lead to the elimination altogether of relocation as a response to introduction of FTT. The continuance of the 'residence principle' in the determination of 'establishment' is likely to encourage deracination of financial services through long-term strategic financial planning, albeit perhaps tempered by consideration of the application of the AAR and the precise form of legislation introduced by the participating member states on implementation of the Revised Directive.

Financial institutions aiming to mitigate FTT liability may avoid trading in securities issued in a participating member state and attempt to ensure transactions are undertaken by entities (such as subsidiary undertakings) established outside the FTT-zone with counterparties outside the participating member state.[35]

OTC derivatives transactions may be used to replicate returns on securities issued within the FTT zone, avoiding trading on an organised platform. While careful notice would need to be taken of the AAR, attention is also likely to be focused on steps necessary to delink such OTC derivatives from the economic substance of any reference security issued within a participating member state.

Funds holding securities predominantly issued by companies outside a participating member state may consider relocation following reorganisation of the funds themselves to segregate securities issued within the FTT-zone on which liabilities may arise.

While no group exemption for FTT exists, intra-group transfers of non-financial instruments and other assets between non-FTT-zone group subsidiaries and branches may be a way of achieving a similar result. Investigation will be needed of the commercial rationale for any such group reorganisation, which will also need to take account of the provisions of the AAR, the extension of the scope of FTT liability to group risk transfers and other tax charges such as VAT.

(ii) Product and business model evolution

Market responses to the implementation of FTT are likely to be evident through the shift of business to products where the costs of FTT liability are less pronounced. It seems likely that the pricing of FTT liabilities into the market for corporate debt securities may result in an increasing preference for credit facility lending by corporate and financial institutions. Alternatively, debt security issuances from EU entities established outside a participating member state may become comparatively more attractive than debt securities issued from within the FTT-zone (with any such trend raising additional questions concerning the potential distortive impact of the FTT within the Single Market).

It also seems likely that commonplace structures and arrangements used for liquidity provision, risk management and routine liquidity financing by financial institutions and corporates will need to be reviewed, and may be significantly more expensive if they remain viable at all in their current form:

(a) On-exchange forex derivative hedging transactions of short-term duration (between one and three months) by corporates, such as those related to fixing payments and receivables resulting from non-EU export and import trading, could become substantially more expensive. Mitigating these costs by utilising OTC derivatives is unlikely to reduce these costs without significant reorganisations of group financing operations. Other forms of routine short-term hedging and risk management using derivatives are likely to be similarly affected.

(b) Deconstruction of a floating rate loan with a derivative hedge into a fixed loan or into a sequence of fixed rate loans may become a method of mitigating exposure to FTT, although caution will be required concerning whether the AAR will counteract such planning.

(c) 'Overnight' repo transactions commonly undertaken by financial institutions could become prohibitively expensive, impairing a common source of funding and risk management. This is acknowledged in the Impact Assessment,[36] with suggestions being made that overnight institutional repos could be replaced with securitised lending transactions or by liquidity transactions with central banks. However, it remains at least questionable whether these alternatives would be as flexible and convenient as arrangements involving overnight repos.

(d) Holding open and exposed positions from an option through purchasing underlying assets, known as 'delta hedging' will become significantly more expensive owing to direct and indirect FTT costs, particularly for long-term options, or short-term options with frequent re-hedging intervals.

(e) 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 unless more expensive cash collateralisation is used. Such developments would be unlikely to add materially to fiscal stability or creditor protection.

These behavioural changes may have a significant impact on the financial markets, perhaps far removed from the anticipated benefits of the FTT in creating incentives to reduce 'undesirable market behaviour'.[37]

Conclusion

With little time remaining before the planned introduction of the FTT, it is likely that financial institutions and market participants will be looking closely at transaction structures to discern where FTT liabilities may arise, and at standard form documentation to identify where the costs of the tax should ultimately be borne. Cross indemnification and changes to transaction and exchange documentation are likely to take time to finalise, not least because the precise collection mechanics for the FTT remain unclear. It would, nevertheless, be surprising if a significant proportion of the costs of FTT liability are not ultimately borne by consumers of financial services, whether institutions, corporate or individuals, through higher financing costs.

While it seems unlikely that the imposition of FTT through enhanced cooperation will pose an existential risk to European financial services, as some early commentators had feared with the original Directive, it does seem likely that the introduction of the tax will lead to significant evolution in market behaviour.

The concerns regarding the introduction of the tax lie not so much with the threat of destabilisation to financial markets as with the fact that the precise context and shape of that evolution is difficult to predict at the current time.

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Endnotes

1. Council Decision 2013/52/EU of 22 January 2013.
2. *Explanatory Memorandum supporting the Revised Directive*, published 14 February 2013 (COM(2013)71l) (the "Explanatory Memorandum"), section 3.3.2.
3. Explanatory Memorandum, section 3.3.2. An exemption for repo transactions continues to be absent even where the purpose of the transfer of a financial instrument under the repo is an ancillary purpose to the main transaction and where the repo is accounted for as a loan, notwithstanding that lending under credit agreements is outside the scope of FTT under the Revised Directive. Paragraph 6.2.3 of the Impact Assessment accompanying the Revised Directive (the "Impact Assessment") explains the reasoning behind the FTT liability imposed on repos, associating such transactions with the spot sale of a security and an accompanying forward contract.
4. Explanatory Memorandum, section 1.2.
5. Article 2(2) of the Revised Directive.
6. Impact Assessment, paragraph 6.2.1.
7. Paragraph 9 of the preamble to the Revised Directive.
8. Impact Assessment, section 6.2.1
9. Impact Assessment, section 6.1.2
10. Similar rules apply for establishing the establishment of a non-financial institution, which is deemed to be established in a participating Member State (i) where it has a registered seat or is resident; (ii) where it has a branch in respect of which financial transactions are carried out; or (iii) where financial instruments are issued and which are the subject of a financial transaction to which it is a party (Article 4.2 of the Revised Directive).
11. Such as under Article 31 of the Markets in Financial Instruments Directive, 2004/39/EC ("MIFID")
12. Article 2(11) of the Revised Directive.
13. However, proposed regulatory changes (such as those proposed regarding MiFID) are likely to result in increasing volumes of derivatives being traded on organised exchanges, potentially resulting in more derivative trading being liable to FTT under the issuance principle than might otherwise be the case. In addition, the proposals under the European Market Infrastructure Regulation (No. 648/2012) ("EMIR") on OTC derivatives, central counterparties and trade repositories will, when implemented, push derivatives onto clearing platforms in the EU.
14. Paragraph 15 of the preamble to the Revised Directive: The Commission have described the issuance principle as minimising "the risk of relocation of transactions, while maintaining a single reference to "establishment" for ease of application".
15. Impact Assessment, section 8.1
16. Article 10(1)(a)-(c) of the Revised Directive
17. Impact Assessment, section 8.1.2 "Member States can assess which systems of tax collection are most appropriate depending on their organisation of markets and infrastructure".
18. Impact Assessment, section 8.2.4
19. Impact Assessment, section 8.1.2
20. An example of the type of information which could be used for FTT compliance and administration is the 'counterparty data' under Table 1 of the Annex to Commission Delegated Regulation No 148/2013 of 19 December 2012 which supplements EMIR.
21. Impact Assessment section 8.2. Particularly noteworthy is the connection which appears to be drawn by the Commission with regular reporting by investment firms of transactions in financial instruments under Article 25(3) of MiFID.
22. Impact Assessment, section 8.2.2.
23. Article 13(1) of the Revised Directive
24. *Halifax plc v Customs & Excise Commissioners* [2006] STC 919, ECJ Case C-255/02
25. *Ministero dell'Economia e delle Finanze v Part Service Srl* [2008] STC 3132, Case C-425/06)
26. Recommendation, clause 4.7
27. A number of these themes are present in the UK Code of Practice on Taxation for Banks (the Code) and, when introduced, were similarly unclear. The expectation in the Code was that banks would discern and comply with "the spirit, as well as the letter, of tax law, discerning and following the intentions of Parliament" (paragraph 1 of the Code). See the author's article in *FITAR* Volume 14, Issue 8 (October 2009).
28. Press Statement, Brussels, 14 February 2013 (European Commission Speech/13/124).
29. Article 10(2) of the Revised Directive.
30. The FTT exemption of 'restructuring operations' under Article 4 of the CDD, without accompanying incorporation of some of the exclusions within Article 12 of the CDD, is difficult to justify. Some restructuring transactions, such as a debt *securities* for equity swaps, would not fall within the exemption for 'restructuring operations' in Article 4 of the CDD, and would therefore be within the scope of the FTT. There seems little in substance to distinguish such a transaction from either 'restructuring operations' within Article 4 of the CDD, or *loan* for equity swaps (which should not fall within the scope of FTT in the first place).
31. *Council Decision authorising enhanced cooperation in the area of financial transaction tax*, 23 October 2012 (COM (2012) 631).
32. National financial transaction taxes have been introduced in France, Hungary, and Italy during 2012 and 2013.
33. The lack of certainty surrounding implementation of the FTT appears to be shared to some extent even by the

Commission which acknowledges that the EU "would to a certain extent enter untested ground" through the development of the FTT. (Impact Assessment, section 8.3)

34. European Commission memorandum: *Financial Transaction Tax through Enhanced Cooperation: Questions and Answers*, 14 February 2013, p. 4
35. Any move towards increasing use of subsidiaries would need to take into account regulatory capital requirements and other tax issues such as controlled foreign companies legislation and domestic anti-avoidance provisions.
36. Impact Assessment, section 6.2.3
37. European Commission *Executive Summary of the Impact Assessment*, 14 February 2013, paragraph 4.

The month in tax

KPMG in the UK summarises recent corporate tax developments of potential interest for FITAR readers

OECD report: Addressing base erosion and profit shifting

The OECD has published a paper on Base Erosion and Profit Shifting (BEPS) which was commissioned by the G-20 and is part of a project looking at whether, and if so why, the current international tax rules allow for the allocation of taxable profits to locations different from those where the actual business activity takes place.

The paper identifies some real issues which need to be addressed, particularly in terms of how international rules keep pace with modern business practices. Two fundamental tensions emerge from the paper. The first relates to corporate behaviour. The paper suggests there is a need to update international tax rules to prevent tax driven structures which lack real economic substance. However it will be necessary to ensure that any changes do not prevent companies from freely choosing the most efficient commercial structures. The second relates to governments. The paper notes it is necessary to stop harmful competition in tax policy. However any changes should respect national sovereignty.

The paper makes it clear that changes should be carried through international consensus and notes unilateral action could create double or multiple tiers of taxation.

The OECD is recommending the development of an action plan to address BEPS issues in a comprehensive manner covering the following areas:

- Hybrid mismatch arrangements and arbitrage;
- Transfer pricing rules (including current work on intangibles);
- Jurisdiction to tax, in particular relating to digital goods and services;
- Anti-avoidance measures such as general Anti-Avoidance rules, Controlled Foreign Company rules, Limitation of Benefits rules and other anti-treaty abuse provisions;
- Treatment of intra-group financial transactions; and
- Harmful regimes.

The aim is to have this plan developed in time for it to be agreed at the next meeting of the Committee on Fiscal Affairs in June 2013.

Tax and procurement

HM Treasury and HM Revenue & Customs (HMRC) have issued a discussion document and draft guidance in respect of promoting tax compliance within the Government procurement process.

Scope of rules

From 1 April 2013 central government suppliers will have to provide self-certification on their tax compliance history when bidding for contracts. The new rules are designed to drive tax compliant behaviour and may exclude suppliers where HMRC have successfully taken action in respect of:

- The forthcoming General Anti Abuse Rule (GAAR);
- Any Targeted Anti-Avoidance Rule (TAAR);
- The 'Halifax abuse' principle (relevant in respect of VAT); and
- Any failed scheme disclosable under the Disclosure of Tax Avoidance Scheme (DOTAS) rules.

Note that no distinction is made between litigation and settlement with HMRC.

To ensure UK suppliers are not disadvantaged, suppliers with tax obligations in foreign jurisdictions will be required to self certify in relation to the equivalent foreign tax rules.

Individuals, partnerships and companies bidding as part of a consortium (and their sub-contractors) are all within the scope of the guidance. Occasions of non-compliance where the amendment to a return was