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The Financial Transaction Tax - 14 questions and answers

The European Commission today released a Directive implementing a Financial Transaction Tax (FTT). If enacted, most transactions in financial instruments involving a financial institution are likely to become subject to the FTT from 2014 if at least one party is established in the EU. If introduced, the FTT would have seismic effects on the EU financial markets.

1. What is the proposed scope of the FTT?

The FTT would apply to **financial transactions** where at least one of the parties is established in an EU Member State and either that party or another party is a **financial institution** (acting as principal or agent).

The definition of financial institutions includes banks, markets, credit institutions, insurers and reinsurers, collective investment funds and their managers, pension funds and their managers, leasing companies and special purpose companies (including securitisation SPVs).

2. What is a "financial transaction"?

Defined to mean the purchase and sale of a financial instrument, repos, stock lending, transfers of risks in financial instruments, and the conclusion or modification of derivatives.

The term "financial instrument" is borrowed from the Markets in Financial Instruments Directive (MiFID), and includes shares, bonds and other securities; options, futures and derivatives; units in unit trusts and other investment funds; repurchase agreements and securities lending. Also covered are "structured products" - tradable securities or other instruments offered by way of a securitisation (as defined in the Capital Requirements Directive) or equivalent transactions involving the transfer of risks other than credit risk.

The scope is very wide, but there are a few obvious omissions: loans, deposits, spot foreign exchange transactions, emissions credits and commodities. The scope also excludes most consumer products: insurance contracts, mortgage lending and consumer credit.

Derivatives are caught regardless of whether the derivative itself or the underlying property is a financial instrument (so for example commodity derivatives would be subject to the FTT).

3. Who is "established" in the EU, and therefore subject to the FTT?

For persons that are not financial institutions the definition of "establishment" is relatively straightforward, capturing place of incorporation and branch location in the manner one would expect.

For financial institutions, the definition in Article 3(1) is quite different.

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A financial institution will be established in a Member State if (applying the following tests in order): (a) it is authorised by the authorities of that Member State; (b) it is incorporated there; (c) it is resident there; (d) it is carrying out the transaction through a branch there; (e) it is party (as principal or agent) to a financial transaction with a financial institution or other entity which is established there.

It follows from paragraph (e) that, e.g. a US bank writing a swap with a French company is established in France for the purposes of the FTT, and therefore liable to pay the FTT. The French company is made jointly liable.

4. Who will pay?

Each financial institution party to a financial transaction (as principal or agent) is required to pay, at the rate applicable in its Member State of establishment. Non-financial institution parties are jointly and severally liable.

As place of incorporation has priority in determining where a financial transaction is established, Member States would not collect FTT revenues from branches of financial institutions that are established in other Member States. This may, for example, result in the UK collecting less FTT than one might have expected.

Where the financial institution is outside the EU, but the transaction is subject to the FTT because another party is in the EU, then the financial institution would be required to pay at the applicable rate in the counterparty's Member State. The counterparty is then jointly and severally liable for its tax.

Note that where a financial transaction has multiple financial institution parties then each would be liable and there would be multiple FTT charges.

The more difficult question is where the incidence of the tax falls – i.e. who will ultimately bear the cost. According to the IMF, most of the burden of an FTT may well fall on consumers.

5. What is the rate?

Member States would be free to set rates, subject to stated minimums, and a general requirement that they not be set so high as to incentivise relocation of transactions within the EU.

The minimum rate is 0.1% generally, charged on the purchase price or other consideration (but where this is less than the market price then the rate is applied to the market price).

A different rule would apply for derivatives, which are proposed to be charged at a minimum rate of 0.01% of the notional amount.

Note that transfers of collateral under derivatives, repos, stocklending etc would be separately chargeable (at the higher rate applicable to securities generally). Accordingly the effective rate of the FTT on most of these arrangements would likely be higher than the headline rates.

6. What will happen to the existing stamp duties on securities in the UK and elsewhere?

It looks like they would be entirely replaced by the FTT (but stamp duties on land will be unaffected). The FTT rate has to be uniform across equities and other financial instruments, so Member States will probably not be able to maintain the existing (relatively high) stamp duty rates.

This is good news for individual investors who, whether investing directly or through pension funds or unit trusts, are likely to benefit from the much reduced rate compared to the 0.5% of stamp duty. It is similarly good news for private equity funds.

It is also, more surprisingly, good news for investors outside the EU (including those in tax havens), who currently often pay stamp duty when buying equities, but would be outside the scope of the FTT if they are buying from another non-EU person.

It is less good news for those Member States who currently have significant stamp duty revenues.

7. How much money would it raise?

The Commission paper estimates the tax itself would raise €16bn to €43bn, but the figure is very dependent upon the degree of dislocation, and previous reports suggest the Commission's original estimate was €10bn. Revenues would be shared between Member States and the EU (partly reducing national contributions).

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The Commission does not however estimate the reductions in receipts from other taxes. Stamp duty revenues are currently quite significant - £4bn in the UK alone. Add to this reduced corporation and personal tax receipts - the Commission's impact assessment anticipates a reduction in economic output of almost 1.8% - and it seems likely the revenue effect of the FTT will be negative.

The FTT is therefore perhaps the first tax in history which is being proposed in the knowledge it will reduce tax revenues.

8. Will it be introduced? When?

The plan is to introduce with effect from 1 January 2014.

However, as it is being proposed under Article 113 of the Treaty of Rome, the Directive will require unanimity at the Council of Ministers.

Most Member States have stated they are in favour of the FTT, with France and Germany speaking out most strongly in favour. There are however, several Member States opposed to the proposal, of which the UK seems most likely to exercise its veto.

If agreement isn't reached, then some Member States may wish to introduce FTTs at a national level. However the legality of this under European law would be questionable. Article 401 of the VAT Directive prohibits turnover taxes. Insurance premium taxes have been held not to be turnover taxes because of their limited scope, and because they are not levied at each stage of the production and distribution process. An FTT is arguably different on both counts. Any Member State introducing an FTT unilaterally therefore risks litigation unless the VAT Directive is amended first (and this again would require unanimity).

There are other problems with unilateral FTTs - the risk of transactions shifting elsewhere would be heightened, and any provisions introduced to counteract this risk contravening the principle of free movement of capital.

9. When and how would the tax be collected?

The tax would be charged at the point the parties enter into the transaction.

Where transactions are cleared or on exchange then the exchange or central counterparty would be responsible for immediately collecting the tax, much like CREST collects UK SDRT. When transactions are OTC, financial institutions would be required to collect the tax and account for it within a period which it is suggested will be three working days (which seems to us an unusually short period).

Every person liable for payment of FTT would be required to submit a monthly return to its Member State tax authority. This includes financial institutions, and others who become liable (e.g. an EU company entering into a financial transaction with a non-EU financial institution).

10. What exemptions are there?

Very few.

Unlike most stamp duties, there's no exemption for brokers, dealers and financial intermediaries. All transactions between intermediaries, when acting as principal, would be subject to the FTT. There would therefore be a cascade effect, as securities traded through the financial system would accumulate FTT charges at each stage of the settlement chain. The likely effect would be to reduce liquidity (increasing bid/offer spreads) and increase the effective rate.

Central counterparties, clearing systems and depositaries are exempt (but persons transacting with such entities are not).

The existing EU prohibition of indirect taxes on capital raising would remain – so the issue of securities and debentures would not be subject to the FTT. The subscription and redemption of shares and units in UCITS and alternative investment funds would however be subject to the FTT.

There is an exemption for financial transactions with the European Central Bank, EU central banks, the European Investment Bank, the European Investment Fund and other supra-national bodies. Central banks of non-EU states are however not exempt.

There is no exemption for intra-group transactions – indeed intra-group transactions are taxed at a deemed arm's length market price (which in the case of e.g. private companies may be hard to determine).

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11. Won't securities and derivative dealing etc just move offshore?

This may well be the consequence. These markets are highly competitive, and the margins of individual trades often very small. Accordingly even small additional costs can make transactions uneconomic. The Commission is itself predicting a fall in derivative transactions of 70 to 90%. This is consistent with Sweden's experience in the 1980s – their bond FTT was set at 0.003% but prompted a fall in trading volumes of 85%.

This is for many people the point of the exercise – but if other major jurisdictions do not introduce an FTT, then the effect may in large part be a geographical shift rather than an actual decline in transactions.

It will of course be easier for financial institutions to transact outside the EU than corporates. But, for example, a multinational group seeking to buy an interest rate hedge from a non-EU financial institution could do so through a treasury company established outside the EU and potentially fall outside the scope of the tax. In each case, where this reflects economic reality, i.e. the relevant personnel and operations are based outside the EU, it will be difficult for any anti-avoidance rules to apply.

The explanatory memorandum acknowledges the importance of ensuring the FTT is uniform across the EU, to prevent transactions shifting from one Member State to another. However the issue of shifting outside the EU is not dealt with. The problem was acknowledged by the Commission itself in a 2010 discussion document - it is not clear why they have changed their mind.

In this respect the FTT is different from most stamp duty regimes (for example in the UK, Hong Kong and Switzerland) which apply to dealings in securities issued by residents, wherever transacted, and whoever the parties are. Such stamp duties cannot be avoided by transacting offshore, and local financial institutions are therefore not disadvantaged.

12. What other effects will the FTT have on behaviour?

National authorities may find policing the boundaries of the FTT to be difficult.

For example, it seems that fixed rate loans would not be subject to the FTT, even though the economically equivalent combination of an interest rate swap plus a loan would be (on the swap element). This kind of anomaly is undesirable in a tax system, as it incentivises inefficient behaviour (large companies generally enter into separate hedging arrangements because they believe they can find better pricing). It also creates a potential arbitrage, and it would not be surprising if some respond by seeking to take market positions by way of lending transactions rather than swaps. Preventing this by way of anti-avoidance provisions would not be straightforward.

Another potential anomaly lies in the different way in which the FTT is proposed to apply to derivatives. Some derivatives have a very large notional amount, and even a 0.01% rate may render them uneconomic. One obvious market response to this would be to reduce the notional amount but then increase the payments commensurately; the explanatory memorandum suggests that Member States may adopt anti-avoidance provisions to counter such perceived abuse. A more subtle market response, and one tax authorities would find it hard to counter, would be to enter into other arrangements which together are economically equivalent to a derivative, e.g. cross-options. The economics may be such that a 0.1% FTT charge on each option is less than 0.01% of principal on the equivalent derivative.

13. Why now?

A combination of economics and politics. There is a view that the financial sector should make a greater contribution towards the cost of the global financial crisis. The IMF, G20 and European Commission have previously considered several forms that this contribution could take, principally VAT on financial services, FTTs and a Financial Activities Tax (FAT) (essentially an additional tax on the profits and employee remuneration of financial institutions). It seemed that a FAT was generally favoured.

However in the last couple of years there has been energetic lobbying by NGOs and others in favour of an FTT, with the revenues used to fund international development. This lobbying culminated in the European Parliament overwhelmingly voting in favour of an FTT, with the revenues to be shared between international development, Member States and the EU institutions. In response, the European Commission was instructed to draw up plans for an FTT (notwithstanding the technical reservations on the FTT contained in previous Commission documentation).

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14. Is this a Tobin tax?

James Tobin's proposal was to enhance international currency stability by introducing a tax on spot currency transactions. The FTT is not a Tobin tax because it doesn't apply to spot currency transactions.

Another fundamental difference is that the Tobin tax was principally intended to change behaviour – the tax would therefore be set at a relatively high rate (perhaps 0.5%) with the intention of discouraging the majority of trading. The FTT is primarily designed to raise revenues, and is therefore set at a much lower rate (which is intended to only discourage a small proportion of transactions).

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