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Briefing note

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# The new EU Financial Transaction Tax: why it seems set to impact financial institutions worldwide, and why legal challenges are likely

Yesterday's ECOFIN meeting resolved to use the "enhanced cooperation procedure" to implement an EU financial transaction tax across France, Germany, and the nine other EU Member States that wish to do so. Most equity, debt and derivative transactions in these jurisdictions will be subject to the tax – from as early as 2014.

The FTT looks likely to have wide extra-territorial effect – those who hoped London wouldn't be affected look to be disappointed; many in the US and Asia may be surprised to find themselves subject to the tax.

We look at some surprising features of the FTT's design and ask: what implications will this have for financial markets in the EU and worldwide? And is the FTT vulnerable to legal challenge?

## What does the ECOFIN decision mean?

In September of 2011, the European Commission tabled a proposal for a Directive implementing a Financial Transaction Tax (FTT) on most financial transactions in the EU (our briefing on the original proposal can be found here).

The proposal required unanimity and, given the opposition by several Member States, it became clear that this would not be achieved. In the Autumn of 2012, eleven Member States requested permission to proceed with a form of FTT based on the Commission's original proposal, but using the "enhanced cooperation procedure". This would enable a smaller group of Member States to proceed with an FTT that would apply in these Member States only.

The European Parliament adopted a resolution last month calling for a Council Decision to allow enhanced cooperation, and the Council formally approved the enhanced cooperation procedure yesterday. The Czech Republic, Luxembourg, Malta and the United Kingdom abstained.

The 11 countries that will form the so-called "**FTT Zone**" are Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia.

# How will the FTT work?

A substantive proposal will be published in the next few weeks. Based on information released to date we expect the FTT to be based on the original 2011 proposal but with several modifications in light of discussions and debate since. If that's right, the FTT will work broadly as follows:

- The scope of the FTT will include all financial instruments (e.g. equities and debt securities) and derivatives, but not loans.
- The FTT will be charged on:
  - transactions in debt securities, equities and entry into/modification of derivatives where at least one party is a financial institution and at least one party is resident in the FTT Zone;
  - transactions in debt securities and equities where at least one party is a financial institution and the issuer of the underlying debt/equity is established in the FTT Zone; and
  - certain other intra-group transactions that transfer risk between entities.
- The FTT will likely also apply to repos, securities lending and collateral transfers.
- The definition of "financial institution" will be wide, including insurance companies, pension funds, most retail and private funds and SPVs. Many M&A transactions and restructurings will be subject to the FTT.
- The headline rate will be a harmonised minimum of 10 basis points of purchase price in the case of financial instruments (with a reduced rate for repos), and a minimum of 1 basis point of notional principal for derivatives.
- The effective rate will be higher. Each financial institution party is separately liable for the tax, so transactions between two financial institutions will be taxed twice. Cascade effects could make the effective rate higher still (see below).
- There will be an exemption for primary market transactions (i.e. subscription/issuance). However there will likely be no exemption for brokers, financial intermediaries or market-makers, and no exemption for intra-group transactions.

# How wide is the extra-territorial effect?

Very wide.

An FTT Zone financial institution's branches worldwide will be subject to the FTT on all of their transactions. So, for example, French and German banks' London branches will be fully subject to the FTT on all their securities and derivatives businesses.

The expected design of the FTT also means that non-FTT Zone financial institutions (e.g. those in London, New York and Asia) will be taxed whenever they transact with parties in the FTT Zone, and whenever they deal in securities issued by an entity established in the FTT Zone. The secondary liability rule means that FTT Zone governments don't need to enforce against those outside the FTT Zone persons, but can simply collect the tax from their own residents.

Clearing systems may magnify the extra-territorial effect, as transactions cleared through clearing systems in the FTT Zone may be subject to the FTT even where the parties and underlying issuer are all established outside the FTT Zone. An obvious example is Euroclear - as Belgium seems likely to be part of the FTT Zone, all transactions cleared through Euroclear may be taxed.

Non-FTT Zone financial institutions that don't want to be liable to the FTT directly will need to monitor the status of their counterparties. To avoid being indirectly liable, they'll need to either ensure their terms and conditions don't permit the cost of the FTT to be passed-on, or police each participant in the chain of clearing/settlement (which may not be possible).

So, whilst there are reports in this morning's Press that the FTT is good news for the City, we are not so sure. Some businesses may migrate from the FTT Zone to the UK. But, given the way the FTT works, and the interconnectedness of modern financial markets, we think it is likely a significant amount of FTT will be collected from UK financial institutions and businesses. It follows that if, as many believe, the FTT causes markets to decline and increases the cost of capital for business, then the UK will be adversely affected (and without benefiting from any of the FTT revenues).

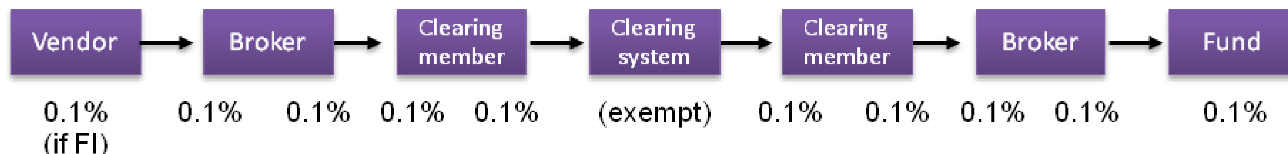
# Doesn't UK stamp duty show that FTTs are workable?

We fear not.

The UK and a number of other jurisdictions have imposed stamp duties and transfer taxes on equities for some time, and those taxes are generally considered to work well. However taxing debt securities and derivatives in the manner proposed by the FTT is quite novel, and its economic effect unclear – both in terms of the impact on financial markets and the cost of capital and hedging for corporates.

Second, most of the existing stamp duties/transfer taxes are based on an issuance principle – so, for example, the UK and France tax worldwide transactions in UK/French equities. There is therefore no incentive for UK and French businesses or funds to relocate from the UK and France, as their stamp/transfer tax liability would be unaffected. But the FTT also applies on a residence principle – a company or fund in the FTT Zone will now be subject to the FTT on its worldwide transactions; if it moved outside the FTT Zone it would not be. Many businesses and (in particular) funds may therefore consider relocating. This seems to us a poor design decision.

Third, the existing stamp duties/transfer taxes generally exempt brokers, market-makers and financial intermediaries. This is the case for the UK, Irish, French and Italian taxes, for example. However, by design, the original FTT has no such exemption, and the Commission has repeatedly stated it does not intend to introduce one. So the sale and purchase of a debt security within the FTT Zone would be charged at multiple stages of the chain of settlement, for example:




The effective rate in this example, which we believe to be fairly typical, will therefore be 1% and not 10 basis points. This "cascade effect" is characteristic of Tobin-style financial transaction taxes. There would be a similar impact for on-exchange derivative transactions and OTC derivatives subject to central counterparty clearing.

If the Commission continue to resist an intermediary exemption then the cascade effect seems to us a serious problem with the proposal:

- The adverse economic impact of the FTT may be considerably greater than anticipated by the European Commission, as its impact assessment modelling did not model cascade effects and the resultant additional costs and distortions.
- Brokers and other intermediaries typically make a very small profit on "riskless principal" transactions such as in the above example – this profit will almost always be less than the FTT charge (perhaps one basis point as opposed to twenty), and therefore the charge will inevitably be passed to the ultimate purchaser of the securities. This potentially represents a very significant hidden cost increase for end purchasers - insurance companies, pension funds, collective investment schemes and others.
- The cascade effect will incentivise parties to transact over the counter rather than on-exchange, at a time when the regulators are encouraging markets to move in the opposite direction.

# What are the next steps?

We expect the next steps to be:

- The Commission will release a detailed proposal, likely in February 2013.
- The Commission's FTT proposal would then be negotiated, with the aim that the final wording of a Directive would be agreed between the participating Member States (following a non-binding opinion from the European Parliament) by September 2013.

- An FTT Directive will be enacted if at that point at least nine Member States wish to proceed (i.e. the other Member States have no vote or veto).
- The participating Member States would then implement the Directive in local legislation.
- The original aim was for the FTT to be effective from 1 January 2014.

# What are the key questions?

We'd hope that by the time a detailed proposal is published, we have answers to the following questions:

- What will be the timescale for implementation? 2014 seems highly optimistic given the complexity and novelty of the tax; 2015 or later seems more achievable.
- Is the cascade effect really intended and, if not, what kind of intermediary exemption will be included?
- How will the FTT apply to the exchange of collateral under derivatives and other financial arrangements?
- How precisely will the FTT apply to derivatives? Taxing the notional principal seems arbitrary, given that in many cases it bears no relation to the actual value of the contract.
- How will the FTT apply to collateral transfers, particularly where there is daily margining?
- What measures will be introduced to prevent relocation? And how far can these measures go without falling foul of EU law (i.e. the prohibitions on restrictions of the freedom of establishment and the free movement of capital)?
- Will the Commission prepare and publish an impact assessment showing the effect of the FTT on Member States within and outside the FTT Zone?

# Will the FTT be challenged?

If the FTT works as outlined above, it is not clear to us that it will be compliant with EU law.

There are very limited precedents for the use of the enhanced cooperation procedure, and no precedent for the EU imposing any taxes other than VAT – but the key difficulties seem to us to be:

- Enhanced co-operation must not undermine the internal market or economic, social and territorial cohesion and must not constitute a barrier to or discrimination in trade between Member States or distort competition between them. It is reasonably clear that the FTT would distort competition between Member States as a whole. A US bank would, for example, be subject to the FTT when transacting with a German client, but not when transacting with (say) a London client. This is a problem recognised by the Commission in its explanatory notes to the original FTT Directive.
- Enhanced co-operation must respect the competencies, rights and obligations of those Member States which do not participate in it. But the extra-territorial effect of the FTT means that residents of non-participating Member States will be subject to the FTT. Indeed, they may be taxed twice – a UK pension fund buying UK equities from a French bank would pay the FTT plus UK stamp duty. The FTT may therefore represent an indirect infringement on the non-participating Member States' competencies and rights.
- There are serious grounds for believing the FTT could constitute a restriction on the free movement of capital, and therefore be contrary to EU law. The Commission has conceded that an FTT that applied to forex would be contrary to the free movement of capital – but EU caselaw draws no distinction between forex, securities and derivatives – all are "movements of capital". So, once the forex point is conceded it is not obvious how an FTT that applies to securities and derivatives can be said to be lawful.
- A key rationale for the FTT was that it was taxing the banks the Commission viewed as responsible for the financial crisis. The difficulty with this argument is that the FTT applies, directly and indirectly, to many entities that have never been blamed for the financial crisis – charities, pension funds, insurance companies, unit trusts and others. The FTT may therefore fail the fundamental EU law requirement of proportionality.

Given the politics of the situation it seems unlikely that any Member State will itself launch a legal challenge to the FTT. However, once the FTT comes into force, anyone subject to the FTT could challenge the legality of the tax in their local courts; this would likely be eventually referred to the Court of Justice of the European Union.

The prospects of a challenge are more than theoretical. There are many precedents of taxing measures being successfully challenged on the basis they contravene EU law. For example, the CJEU ruled in 2009 that the UK's application of stamp duty to the issue of shares into clearance and depositary systems was unlawful, and this is expected to cost the UK up to £5bn in refund claims.

Any challenge to the FTT would be considerably more controversial, and the prospects of success unclear. But given the vast sums involved, legal challenges seem certain, and the potential cost to the FTT Zone states very substantial. Whether this will give EU institutions and Member States pause before proceeding with the FTT remains to be seen…

# Further information

If you would like further details on any aspect of the FTT, or how it applies to your institution or transactions, please speak to your usual Clifford Chance contact or any of those listed overleaf.

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