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Briefing note

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The European Commission's financial transaction tax proposal – what it means for investors and institutions in Europe and worldwide

The European Commission today published its detailed proposal for an EU Financial Transaction Tax to be implemented under the "enhanced cooperation procedure" across France, Germany, and nine other EU Member States. If adopted, most equity, debt and derivative transactions in these jurisdictions will be subject to the tax – from as early as 2014.

As we predicted in our January briefing, the tax has wide extra-territorial effect. Pension funds, insurance companies, unit trusts, banks and businesses in the UK, Ireland, Luxembourg and worldwide will be subject to the tax on many of their transactions. The "cascading" design of the tax means that its effective rate will be considerably higher than the headline rates.

We ask: what implications will this have for financial markets in the EU and worldwide? And will such an extra-territorial tax survive legal challenge?

The background

In September 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 amongst the 27 member countries of the EU and, given that several were opposed, it soon 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 supporting the use of enhanced cooperation in this area, and the Council formally approved the enhanced cooperation procedure on 22 January. The Czech Republic, Luxembourg, Malta and the United Kingdom abstained.

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

How does the proposed FTT work?

As we anticipated in our previous briefing on the FTT (see here), the tax is closely based on the original 2011 proposal but with several modifications in light of subsequent discussions. The basic framework of the proposal is as follows:

- The scope of the FTT includes all financial instruments (e.g. equities and debt securities) and derivatives, but not loans.
- The FTT is 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 established 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 also applies to repos and securities lending, although only one "leg" of the repo/stock loan is subject to the charge (as opposed to both "legs", as was envisaged in the original 2011 proposal).
- The FTT also seems likely to apply to the posting and return of collateral (although this remains unclear).
- The definition of "financial institution" is wide, including insurance companies, pension funds, most retail and private funds, SPVs and holding companies. Many M&A transactions and restructurings will therefore be subject to the FTT.
- The headline rate for financial instruments is a harmonised minimum of 0.1% of purchase price (or market value if greater). For derivatives, the rate is a minimum of 0.01% of notional principal. However 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).
- The FTT applies to all financial transactions, whether OTC or on-exchange. Where financial transactions are effected by " electronic means", the tax must be paid immediately; in other cases the tax must be paid within three days.
- There is a broad anti-avoidance provision that disregards any arrangements that have the effect of reducing or avoiding the application of the FTT. So, for example, any arrangements that artificially reduce the notional principal of a derivative whilst leveraging payments under it by the same amount would potentially be taxed as if the notional principal had not been reduced.
- A specific anti-avoidance rule addresses the possible use of depositary receipts to minimise or avoid FTT charges on trading in the underlying securities.

What exemptions are there?

Exemptions are very limited:

- Loans are outside the FTT entirely, as are spot forex transactions (but FX forwards and currency derivatives are taxable).
- There are exemptions for the Member States themselves, their central banks, other supra-national bodies and central counterparties and depositories - however persons transacting with such entities will still be taxable.
- As required by EU law, there is an exemption for primary market transactions (i.e. subscription/issuance).
- There is no exemption for brokers, financial intermediaries or market-makers unless (unusually) they are acting for another on a disclosed agency basis.
- There is no exemption for intra-group transactions - corporate reorganisations and internal funding and hedging arrangements may therefore be subject to multiple FTT charges.
- Despite much lobbying, there is no exemption for pension funds.

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 design of the FTT also means that non-FTT zone financial institutions (e.g. those in London, Dublin, Luxembourg, 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. In such a case they are deemed "established" in the FTT zone and taxed. The joint and several liability rule then 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.

The extra-territoriality is in principle limited by an exception for cases where the person liable to tax can show there is no link between the economic substance of the transaction and the territory of any participating Member State – however it is unclear when (if ever) this exception would be engaged.

So, whilst there have been some press reports that the FTT is good news for the City, we are not so sure. There may be some relocation 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 businesses.

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.

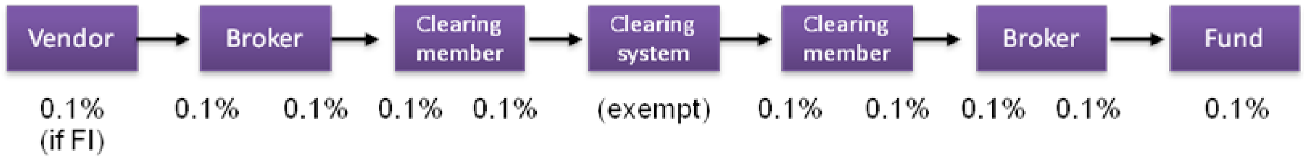
Third, the design of the FTT creates a highly distortive "cascade" effect.

What is the cascade effect?

Most taxes operate on a net basis. For example, VAT applies to the net value added at each point of the production of goods and services; corporation and income taxes apply to the net profits from a year's activities. By contrast, the FTT applies on a gross basis and separately to each element of each financial transaction – it "cascades".

This is exacerbated by the lack of an intermediary exemption. 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. By design, the FTT has no such exemption, and the Commission has repeatedly stated it does not intend to introduce one.

The sale and purchase of a debt security within the FTT zone would therefore 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. This would seem to 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.

Given that brokers and other intermediaries typically make a very small profit on "riskless principal" transactions such as in the above example, the cost will inevitably be passed to the end-investor.

Additional cascade effects will hit any transaction that has a number of separate elements. For example:

- Many businesses that hedge foreign currency exposure do so with rolling one month FX forwards – each would be separately taxed. If financial collateral is posted by either party to support a forward then this will also be taxed, potentially multiple times.
- Many banks fund themselves by overnight repos of their inventory. This would result in an annual FTT charge of up to 25% (if we ignore settlement cascade effects) or up to 250% (if we take settlement cascade effects into account).
- Funds are particularly prone to cascade effects. For example, investors in an open-ended investment company (OEIC) will suffer the cascade effect when they buy shares in the OEIC itself. The OEIC will then be subject to cascading FTT charges when it buys and sells securities, and again if it seeks to enhance its return by lending its securities to financial institutions.

Cascade effects are a widely understood feature of financial transaction taxes; it is therefore surprising that the Commission's impact assessments did not anticipate or model cascade effects. Many are concerned that the adverse economic impact of the FTT may therefore be considerably greater than the Commission anticipates – indeed given the differential between the 0.1% rate the Commission modelled, and the 1% effective rate in the example above, the Commission's estimates could be out by an order of magnitude.

A recent IMF report concluded that gross transaction taxes like the FTT cascade and distort production, and should be avoided when more efficient taxes are available. We would agree. Without intermediary exemptions we do not see how the FTT is workable.

What are the next steps?

We expect the next steps to be:

- The Commission's FTT proposal will be negotiated over the next few months, potentially with Member States joining and leaving the group of participating Member States as negotiations proceed (this has been the experience with the previous enhanced cooperation measures).
- The final wording of the Directive will then be agreed between the participating Member States (following a non-binding opinion from the European Parliament) by the Summer.
- The FTT Directive will be enacted if at that point at least nine Member States wish to proceed (i.e. the Member States that have not opted in have no vote or veto).
- The participating Member States would then implement the Directive in local legislation by 30 September 2013.

- The FTT will be effective from 1 January 2014.

This seems a challenging timeframe for governments, tax authorities and taxpayers. The recent French and Italian FTTs were implemented within similar three month periods, but the accelerated timescale resulted in a number of uncertainties which taxpayers and tax authorities are still in the process of resolving. Given these experiences, and that the EU FTT is significantly more complex than the French and Italian taxes, we would hope that implementation is pushed back.

How will markets react to the proposal?

If the FTT is adopted in close to its current form, some of the reactions we would expect are:

- Companies and financial institutions that don't want to incur FTT liabilities may put measures in place to ensure they don't trade with parties in the FTT zone, or in FTT zone securities.
- They may also wish to amend their terms and conditions and transaction documentation, e.g. requiring their counterparties to represent they are not "established" in the FTT zone and excluding the FTT from any costs indemnities.
- More generally, the novel aspects of the FTT mean that existing risk and cost allocation provisions in standard derivative and securities documentation will in many cases need to be amended, particularly given the joint and several liability the FTT creates.
- The pricing of corporate and government bonds may reflect direct and indirect FTT charges, and this may cause (to some degree) a move by corporates away from bond financing and towards loan financing.
- If, as seems to be the case, the posting of financial instruments as collateral is subject to the FTT, then there may be a move towards increased use of cash collateral. Similarly, if on-exchange transactions remain subject to the deleterious cascade effects outlined above, there may be a move towards OTC transactions.
- In some markets it is customary for businesses to borrower under floating rate loans and then enter into a fixed/floating interest rate swap; there would now be an incentive to replace this kind of arrangement with a fixed rate loan.
- As noted above, short term transactions that ordinarily roll-over will incur multiple FTT charges; an economically identical long term arrangement with an early break provision would not.
- From 2014, any amendment to a historic financial transaction would trigger an FTT charge if viewed as a "material modification" it may trigger an FTT charge.
- Investment funds currently established in the FTT zone but which hold non-FTT zone securities may materially benefit from relocating to outside the FTT zone.
- Of course, any arrangements that have the effect of minimising FTT liability would need to be carefully considered in light of the general anti-avoidance rule in the Directive.

Will the FTT be challenged?

It is not clear to us that the current proposal for an FTT will be compliant with EU law.

The Commission's explanatory memorandum asserts in several places that Treaty requirements are satisfied, but without setting out any reasoning. 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. 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 infringement on the non-participating Member States' competencies and rights.

- The EU only has power to introduce taxation measures to the extent that harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition. We are unaware of any proposals by individual Member States to introduce taxes similar to the FTT; accordingly it is difficult to see this as a harmonisation measure. Furthermore, it is unclear how the FTT can be said to "avoid distortion of competition" – if anything, the opposite is the case.
- 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, FX forwards, 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 is stated to be that it is taxing the banks the Commission view 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.

A Member State could itself launch a legal challenge to the FTT at the Court of Justice of the European Union, and there have been indications that Luxembourg (amongst others) may be willing to do this if the extra-territorial impact of the tax is not reduced. Alternatively, 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 CJEU.

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. This does not seem to have influenced the Commission's decision to press ahead with the tax. Whether it will give the eleven 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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