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EU FINANCIAL TRANSACTION TAX – FINALLY, THE TIDE TURNS

TAX

The prospect of a Financial Transaction Tax in the EU (FTT) has significant implications for global financial markets. The subject has been heavily debated since the European Commission published the first draft directive in 2011. Having been roundly rejected by the majority of EU member states, 11 jurisdictions[1] obtained approval in February this year to continue with the proposals under the otherwise little-used "enhanced co-operation" procedure.

Despite the supposed narrowing in scope, the draft directive, as it currently stands, would still affect a far wider range of transactions and taxpayers than might be expected. It is the subject of severe criticism, in particular for its perceived extra-territoriality; the UK has launched a legal challenge in the European Court of Justice on that ground.

Thankfully, if recent financial media reports are to be believed, the EU FTT proposals will need to be scaled down dramatically in order to survive. The critical question at present is whether - and if so when - nine or more of the 11 member states involved will be able to agree unanimously on the scope of the tax.

If the FTT cannot be progressed via enhanced co-operation, the realistic alternative is a number of different financial transaction taxes in different member states. There is too much political capital in the idea for it to simply fall away. France and Italy have already implemented their own financial transaction taxes and, in the absence of some form of EU FTT, more are bound to follow (despite lessons learned from jurisdictions like Sweden, which have tried introducing such taxes but found them unworkable). So the best that can be hoped for is likely to be a narrower FTT with reasonable exemptions that will prevent a plethora of new, different and potentially complicated regimes springing up.[2]

PRINCIPLES

In theory, the key principles behind the EU FTT proposals are to require financial institutions responsible for the recent financial crisis to pay for economic support they received during the crisis and to discourage financial activity that is perceived to be risky, or not economically useful. A third is the raising of funds for participating member states; the figure of €30-35bn was floated as the potential annual revenue to be raised from the FTT.

However, the draft directive published in February goes far beyond what would be required to put the first two of those principles into practice and arguably renders the third impossible, given the implications of the tax for liquidity and international financial markets.

SCOPE

The current draft directive is stated to apply to all "financial transactions" in two sets of circumstances:

- where at least one party to the transaction is a "financial institution" established in a participating member state (whether or not acting in its own name) (the Residence Principle); and
- where the "financial instrument" concerned has been issued in a participating member state (though OTC derivatives are excluded from this head of charge) (the Issuance Principle).

The draft definitions of "financial transaction", "financial institution" and "financial instrument" are all deliberately broad (and many types mentioned in the directive are borrowed from other directives already in force). More information on them is given below.

Primary market transactions (e.g. the issue of shares or new loan capital) are outside the scope of the draft directive. The explanatory memorandum accompanying it states that "most day-to-day financial activities relevant to citizens and businesses" are excluded from charge, citing examples such as insurance products and mortgage lending.

However, the secondary lending market is also very much part of everyday financial activity in the UK - that is plain to see from the range of standard documentation available from the Loan Market Association (LMA) in addition to the way in which the LMA primary documentation works in practice to allow syndication etc. But, aside from making arguments that a facility agreement is not a financial instrument, it is not clear from the draft directive that, for example, a sub-participation in an existing LMA facility is outside the scope. In addition, hedging arrangements – even those that are a standard and indeed necessary part of the financing arrangements for many corporate groups with banking facilities - are clearly caught.

DRAFT DIRECTIVE – KEY POINTS

- The minimum tax rates would be 0.1 per cent of the consideration given for the securities for dealings in securities (equities, bonds etc) and 0.01 per cent of the notional amount (or the highest notional amount if there is more than one) for derivatives. Trades in currencies different to that of the taxing jurisdiction are to be translated into that jurisdiction's currency.

[1] France, Germany, Spain, Italy, Portugal, Greece, Austria, Belgium, Estonia, Slovakia and Slovenia
[2] The FTT is intended to operate on the basis that it replaces individual country financial transaction taxes.

- Each transaction would be taxed at least twice as each party to a transaction would be liable for the tax. Joint and several liability is proposed to ensure collection (so if one party does not pay, the other pays both charges). Each leg may be chargeable in a different jurisdiction, depending on where the parties are based, or the instrument in question is issued.

- Mercifully (relatively speaking), each repo and stock loan would be treated as a single transaction rather than a separate sale and repurchase (i.e. subject to one FTT charge per party rather than two, though there are concerns about additional charges on collateral movements). However, their economic equivalent, secured loans, should not incur the tax at all. In contrast, an exchange of instruments would be treated as two separate transactions. The tax would generally be payable immediately (for electronic transactions) or within three working days of the trade taking place (for other transactions).

- No exemptions are proposed for intermediaries, market makers, intra-group transactions, pension funds or sovereign debt. A very limited "cascade" rule will do little to relieve multiple charges in practice. So the cost of a typical chain of settlement for dealing in bonds could be as much as (or even more than) 1 per cent.

- The proposals include wide-ranging anti-avoidance rules, so structuring to avoid FTT may not be effective. The position is further confused by the absence of grandfathering provisions in the draft directive and its treatment of "material modifications" to instruments (even if FTT had already been paid on them) as triggers for additional charges.

- Despite the principle that financial institutions should bear the costs of the FTT, there is nothing in the draft directive to protect end users from suffering the charges in practice.

- The FTT was intended to come into force on 1 January 2014. This timing is almost inconceivable now, particularly given the German election this autumn. However, the political momentum behind the proposals should not be underestimated. While 2015 would be more realistic (for whatever form of FTT may be agreed), it is possible that some form of legislation could be pushed through in the course of 2014.

CRITICISMS OF THE CURRENT PROPOSAL

So why is the current proposal being labelled unworkable? The UK Chancellor of the Exchequer, George Osborne, recently summed it up as "poorly timed, badly designed and … unlawfully extra-territorial" in a letter to the Chief Executive of the European Banking Federation.[3]

The key concerns about the FTT (at a macro level) are as follows:

- **It is extra-territorial:** the issuance principle, the requirement for a non-FTT zone financial institution to bear the tax on the grounds that its counterparty is established in the FTT zone and the treatment of branches as established in the FTT zone all have consequences for international trade far beyond the FTT zone. It is possible that jurisdictions outside the FTT zone with more significant financial markets (e.g. the UK and the US) may suffer disproportionately from the reduction in the pool of available and/or willing investors in instruments such as bonds.

- **The timing is indeed poor:** many countries – including several in the FTT zone – are still suffering severely from the global recession and should now be focusing on growth. In contrast, the FTT is expected to reduce liquidity and shrink financial markets.

- **It will not achieve its objective of raising funds from financial institutions:** there is no protection against end-users (including individual pensioners or savers as well as corporate groups) bearing the cost of FTT. The Financial Times has reported a survey carried out by the Deutsches Aktieninstitut which estimates the cost of the FTT to German corporate groups of around €600m to €1.5bn.[4]

- **It will raise far less money than forecast in any event:** not only will the FTT curtail growth and depress markets, it will cause significant behavioural change. Many businesses (including hedge funds and corporate groups) would not be able to sustain the level of costs and would need to change their business models. For example, the exclusion of OTC derivatives from the issuance principle could lead to an increase in the use of derivative products rather than a reduction.

[3] The full text of the letter can be found at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/205346/letter_cx_guidoravoet_050613.pdf
[4] Article 8 May 2013 by James Wilson

WHERE NEXT FOR THE PROPOSALS?

While the EC has dismissed, as "sensationalist", reports of disagreements between FTT zone jurisdictions as to the form and scope that the FTT should take, the sheer volume of reports on lobbying by numerous interested parties cannot be ignored. From governments to central bankers and businesses, trade associations and professional bodies, much is being said about the FTT that suggests it cannot survive the enhanced co-operation process as it currently stands.

(There are some parallels to be drawn with the progress of the US FATCA legislation last year, when the sheer weight of the lobbying from many different fronts, and in different forms, forced the US government to listen to concerns and clarify – and in part water down – its proposals.)

SO WHAT MIGHT CHANGE?

- A reduction in the scope of the proposed FTT is surely needed in order to make it feasible. Territoriality must be respected and the very broad rules extending the natural meaning of the word "establishment" must be significantly narrowed down.

- At the very least, exemptions must be included for market makers and other intermediaries, pension funds and intra-group transactions. A number of these already feature in the transaction taxes introduced recently by France and Italy.

- Better still, an exemption for repos would be a significant positive change to support the markets and liquidity.

- The legislation should be clarified to ensure transactions that are not in substance sales or similar trades – for instance, transactions creating or reflecting security interests - are not taxed. At present there are concerns that posting collateral may be taxed, which does not reflect the principles behind the FTT and would only serve artificially to inflate FTT charges.

- There are hints of a reduction in rates from 0.1 per cent to 0.01 per cent on all trades, irrespective of underlying security. Staged implementation also appears to be under discussion, i.e. the regime may apply first to equities and only later to bonds and derivatives. Both of these moves would be welcomed, though they would need to be introduced to complement a narrowed down version of the tax; these changes alone would not resolve all of the relevant issues.

- Another approach can be seen in a revised proposal by those pushing the FTT forward, which was approved by the Economic and Monetary Affairs Committee of the European Parliament on 18 June (though the European Parliament does not have decision-making powers on tax matters). The proposal includes lower introductory rates of tax on sovereign bonds and on trades in equities, bonds and derivatives traded by pension funds. However, it also includes the potential to tax OTC transactions at higher rates than those currently proposed and anti-avoidance proposals to require payment of the tax before transferring legal ownership of the relevant security or instrument. There is also talk of introducing some form of intra-group exemption.

THE FTT: KEY TERMS IN THE DRAFT DIRECTIVE

- **Financial institution:** includes investment firms, regulated markets, credit institutions, UCITS, pension funds, alternative investment funds and their managers, securitisation vehicles and any other entity carrying on financial activities– e.g. participation in or issuing financial instruments, or providing related services, and acquiring holdings in undertakings, if such activities constitute more than 50 per cent of their average net.

- **Financial instruments**: include "transferable securities" (broadly, securities that are negotiable on capital markets – e.g. shares and bonds), money-market instruments, units in collective investment undertakings and many types of derivative contracts.

- **Financial transactions**: generally include the sale and purchase or exchange of financial instruments, conclusion of derivatives contracts, repos, reverse repos and stock loans.

- **Establishment in a participating member state:** a financial institution is deemed to be established in the territory of a participating member state if it:
    - is authorised to operate in participating member states;
    - has its registered seat in participating member states;
    - has its permanent address in a participating member state;
    - has a branch in a participating member state (but only for transactions which that branch carries out);
    - is a branch of a financial institution based in a participating member state;

- is a party to a financial transaction with another financial institution established in that member state; and
- is a party to financial transactions involving underlying securities issued in a participating member state to be established in that participating member state (the issuance principle).

PREPARING FOR THE IMPACT OF THE FTT: SOME PRACTICAL POINTS

We are clearly some way off having a coherent, unanimously agreed FTT regime. However, while the proposed regime is being developed, there are a few practical steps that can be taken to prepare for whatever eventually emerges from the discussions.

- To the extent that they have not already done so, business models should be reviewed to see whether any (and if so which) aspects of an entity's business are likely to be vulnerable to the proposed changes.

- When negotiating new agreements involving financial instruments, businesses should assess the risk that they may be required to indemnify counterparties for financial transaction taxes and how they might exit the trade or other arrangement if unacceptable FTT costs fall on them.

- Given the lack of grandfathering provisions in the draft legislation, existing agreements in this area should also be checked. Again, tax indemnity provisions and exit provisions are likely to be the most important clauses to consider.

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