Financial Transaction Tax Set For Delay

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The UK government has begun legal proceedings to challenge the decision of a subset of the EU, 11 of the 27 Member States, to adopt a financial transaction tax ("FTT"). The UK challenge coincides with widely held and publically expressed concerns by Member States (both participating and non-participating), as well as by industry bodies and individual tax-payers, over the scope and enforceability of the proposed tax.

The UK's legal challenge will not suspend the negotiations of the 11 Member States who wish to adopt the tax ("the FTT-zone") but they highlight the concerns regarding the extraterritorial reach of the proposed tax. Draft provisions, which contain what is being called "the issuance principle," bring within the scope of the tax financial instruments issued in the FTT-zone regardless of where they are traded or where the parties to the transaction are established so long as a financial institution is party to the transaction whether or not it is acting as principal or agent. There are other provisions which, contrary to the normal approach of financial services legislation, bring within the scope of the tax FTT-zone branches of financial institutions established in countries outside the zone and financial institutions wholly outside the FTT-zone which merely have a permission to trade in the FTT-zone.

Various US industry groups have written to the European Commission to warn that the FTT would hurt the US and other economies, harm consumers and damage international relations and a number of industry bodies from other third country jurisdictions have written to G20 leaders to protest at the tax's proposed extraterritorial effect.

Perhaps most pertinent are the FTT-zone countries' own concerns. On April 16, 2013 they sent a memo to the Commission asking for clarification of a number of issues, including the impact of the FTT on the cost of sovereign and corporate debt. Although the raising of capital through, for example, the issuance of shares and bonds on the primary market is excluded from the scope of the FTT, the trading of debt instruments, including sovereign debt, on the secondary market is not exempt. In addition, there is concern that the application of the FTT to repurchase agreements would

make such agreements, especially overnight repos, economically unviable. The possibility of the extinction of the repo market, an important source of liquidity, plus the application of the tax to secondary market trading has raised concerns of a negative effect on the bonds market and a consequent increase in the cost of funding for governments and corporates alike.

Other areas of concern are the inclusion of pension funds as financial institutions liable for the tax and the lack of exemptions for derivatives, hedging and market-making. One general criticism that can be levied against the FTT is that it is inconsistent with the general direction of travel of the EU, particularly at a time when there is a need to encourage EU economic growth and competitiveness. For example, the likelihood that the posting of collateral is within scope of the FTT appears inconsistent with both the EU regulation on OTC derivatives ("EMIR") which requires the exchange of collateral as a risk-mitigation technique for uncleared OTC derivative trades and the fact that interbank lending is moving from an unsecured to a secured basis.

Enforcement also remains a concern, particularly where financial institutions are outside the FTT-zone. One apparent means of addressing this concern is the proposal that there be joint and several liability for the payment of the tax amongst the parties to the transaction, extending to entities which would not otherwise be liable for the tax, such as central counterparties and central securities depositories and entities which are not financial institutions. Such liability raises its own practical and legal concerns.

Relocation, as a means of avoiding the FTT, is a real concern for countries within the FTT-zone. It is one of the reasons that the issuance principle was added to the proposal but a possible consequence is that financing transactions may migrate towards offshore financial centres located outside the EU, particularly if derivative brokers or market dealers have relocated there. A longer term development may see a reduction in the trading of FTT-zone securities, or trading with financial institutions within the FTT-zone. Even the Commission concedes that the proposal could result in a 75 percent drop in derivative transactions and a 15 percent reduction in cash volumes.

It appears unlikely that the envisaged timetable for the introduction of the FTT will be met. The ambitious plan was for the national legislation implementing the tax to be in place by September 30, 2013 and to apply from January 1, 2014 but political agreement before the German elections in September 2013 is looking unfeasible. For the reasons set out above, it also appears unlikely that the FTT will be adopted in its current form yet, despite all the vocal criticisms, some form of EU FTT remains on the cards.