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Legal Update
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A global financial transaction tax by any other name?

On 14 February 2013, the European Commission published a proposal for a financial transaction tax ("FTT") to be introduced in a subset of the EU: Germany, France, Spain, Italy, Belgium, Austria, Estonia, Slovenia, Slovakia, Portugal and Greece. The scope of the proposal is such that it is being termed a global financial transaction tax. Should it be adopted, the tax will come into effect on 1 January 2014.

Potential impact

If the proposal is adopted, it has the potential to impact all parties to financial transactions which have a link with one of the 11 participating countries ("the FTT-zone"), irrespective of whether or not those parties are established in one of those countries. The exact impact will depend on the detail of the operational model of each business and the precise way in which the FTT is implemented by each country, but it is worth noting the following points:

(a) the tax is payable by all parties to a transaction, i.e. by both the buy and the sell side;

(b) the use of financial institutions as intermediaries will potentially bring the activities of non-financial institutions within the scope of the FTT;

(c) the rate will be at least 0.01% on the notional principal of derivatives and 0.1% of purchase price (or market value, if higher) on all other financial instruments;

(d) structured products, as well as shares, bonds and derivatives, are liable for the FTT;

(e) intra-group transfers of the right to dispose/the risk of a financial instrument are within the scope of the FTT;

(f) given the complexity of many financial agreements which are likely to involve more than one "financial transaction" as defined in the proposal, some products and transactions will be subject to double or multiple taxation;

(g) the exchange of financial instruments will give rise to two transactions and thus two liabilities for taxation;

(h) repurchase agreements, reverse repurchase agreements and securities lending and borrowing agreements are within the scope of the FTT;

(i) the posting of financial instruments as collateral is within the scope of the FTT;

(j) additional collateral received in response to each margin call is likely to be regarded as a new financial transaction for the purposes of the FTT;

(k) many post-trade risk mitigation activities are within the scope of the FTT;

(l) there is no exemption for Treasury activities, such as hedging, nor for market-making;

(m) arrangements under which a custodian or depository receives the legal title to financial instruments could be liable for the FTT;

(n) sweep facilities could be liable for the FTT;

(o) modifications to any financial transaction which are regarded as material will be treated as a new financial transaction and liable for the FTT.

These points are explained further in the section below entitled *Scope of the proposal*.

Background and legal context

The Commission adopted a proposal for a Directive on an EU-wide FTT in 2011. It became clear throughout 2012 that there was not unanimous support for the FTT and, as unanimity is required for the introduction of fiscal measures in the EU, it was not possible for an EU-wide measure to be introduced. A subset of EU countries still wished to proceed, however, and it now appears likely that they will adopt a FTT through a little used procedure known as "enhanced cooperation".

Enhanced cooperation requires nine or more EU countries to participate, although other countries retain the right to join subsequently. Essentially, the procedure allows a subset of countries to proceed with a measure that does not have enough support to be adopted by all 27 EU countries, but there are legal conditions that must be satisfied in order for the procedure to be used. In particular, the measure must not: (i) undermine the internal market or economic, social and territorial cohesion; (ii) constitute a barrier to or discrimination in trade between EU countries; or (iii) distort competition between them. Enhanced cooperation must also respect the competences, rights and obligations of those EU countries that do not participate in it. Some of the non-participating EU countries have raised legal concerns that the conditions for enhanced cooperation are not fulfilled in the context of the proposed FTT. There is thus the possibility that some of the non-participating EU countries may seek to challenge the FTT before the Court of Justice of the EU.

Scope of the proposal

In summary, the FTT will be payable in respect of a "**financial transaction**" if:

(a) any party to a financial transaction is "established" in the FTT-zone and a financial institution is party to the transaction (acting as principal or agent), irrespective of where the transaction takes place ("the residence principle"); or

(b) if a financial instrument issued in the FTT-zone is traded anywhere and a financial institution is party to the transaction (acting as principal or agent), even if no party to the transaction is established within the FTT-zone ("the issuance principle").

Although one party to the transaction must be a **financial institution** (acting as agent or principal), the term is widely defined. It includes the expected bodies (banks, investment firms, (re)insurers, UCITS, alternative investment funds and alternative investment fund managers, SPVs, securitisation special purpose entities, regulated markets and any other organised trade venues or platforms) and, surprisingly as there was an expectation that they would be carved out, it includes pension funds and their managers. It also includes any other body which carries out a significant number of financial transactions, meaning transactions which constitute more than 50% of its average net annual turnover.

The term "**financial transaction**" is also drafted widely to include any of the following:

(a) the purchase and sale of a financial instrument (before netting or settlement);

(b) the transfer within a group of the right to dispose of a financial instrument and any equivalent operation implying the transfer of the risk associated with the financial instrument;

(c) the conclusion of derivatives agreements (before netting or settlement);

(d) the exchange of financial instruments; and

(e) repurchase and reverse repurchase and securities lending and borrowing agreements.

Material modifications of any of the above will be treated as a new taxable financial transaction. Modifications will be regarded as material where they involve a substitution of at least one party, alteration of the agreed consideration or the object or scope of the underlying transaction or where the original transaction would have attracted a higher tax had it been concluded as modified.

The term "**financial instrument**"[1] essentially comprises shares, bonds and equivalent securities, money-market instruments, units and shares in collective investment undertakings and other funds and derivatives. It also includes structured products which are defined as tradable securities or other instruments offered by way of a securitisation (within the meaning of the Capital Requirements Directive) or equivalent transactions involving the transfer of risks other than credit risk. As set out above, the term also effectively includes repurchase and reverse repurchase and securities lending and borrowing agreements.

In respect of each single financial transaction, a financial institution will be taxed in the following circumstances:

(a) if it is a party to the transaction, either acting for its own account or the account of another person;

(b) it is acting in the name of a party to the transaction; or

(c) the transaction has been carried out on its account.

Where a financial institution is acting for another financial institution, only the principal financial institution is liable for the tax. The extraterritorial provisions of the proposal raise questions as to enforceability which may be why the proposal provides that, where the tax is not paid on time, each party to the transaction, including persons which are not financial institutions, shall be jointly and severally liable for payment. Subsequent cancellation, save in the case of errors, will not remove the liability for taxation.

The proposal is in the form of a directive, which means that it must be implemented in each of the participating countries, but it contains minimum levels of taxation of 0.01% on derivatives and 0.1% on all other financial instruments. The tax on instruments other than derivatives will be set by reference to the purchase price or other consideration, or the market price if the actual price is less than the market price (in the case of intra-group transactions, for example), whereas the tax on derivatives will be fixed by reference to the (highest) notional amount referred to in the derivatives contract.

1 The term "financial instrument" in this regard is defined by a cross-reference to the Markets in Financial Instruments Directive. The instruments within the scope of this provision are essentially the same instruments covered by the general definition of financial instruments save that the derivatives must be traded on organised trade venues or platforms.

The tax is payable to the tax authorities of the country in which the financial institution is established.

The proposal contains a specific anti-abuse rule which provides that the economic substance of a transaction will be taxed if an artificial arrangement has been put in place to avoid the "object, spirit and purpose" of the FTT.

When is a party to the transaction "established" in the FTT-zone?

The extraterritorial application of the FTT is based on the "residence" and "issuance" principles which are outlined above. The residence principle means that a financial transaction is liable for the FTT if one of the parties to the transaction is established within the FTT-zone. The term "established" is given a wide meaning and includes:

(a) a financial institution authorised by a participating country in respect of a financial transaction being carried out;

(b) seemingly a financial institution authorised outside the FTT-zone which is either an EEA-authorised institution using a "passport" to trade in the FTT-zone or a third country institution permitted to trade in the FTT-zone[2];

(c) a financial institution (or a natural or legal person that is not a financial institution) with its registered seat, permanent address or usual residence in the FTT-zone;

(d) a financial institution (or a natural or legal person that is not a financial institution) with a branch in the FTT-zone in respect of a financial transaction being carried out by that branch;

(e) a financial institution that is a party (as agent or principal) to or acting for a party to a financial transaction with another financial institution in the FFT-zone or with a party in the FTT-zone which is not a financial institution;

2 This provision is not limited to transactions carried out within the FTT-zone using the passport but it is not clear whether this is what is intended or whether this provision attempts to deem financial institutions to be established within the FTT-zone simply because they have a passport (or third-country authorisation) to trade within the zone.

(f) a financial institution that is a party (as agent or principal) to or acting for a party to a financial transaction covered by the issuance principle; and

(g) a natural or legal person who is a party to a financial transaction covered by the issuance principle.

What is outside scope?

The general day-to-day financial activities of citizens and businesses (such as loans, including corporate loans, mortgages, insurance transactions and deposits) are outside the scope of the FTT, as is the raising of capital through, for example, the issuance of shares and bonds on the primary market, and certain restructuring operations. Spot currency exchange transactions, public debt management and monetary policy are also excluded. The trading of debt instruments, including sovereign debt, on the secondary market is not, however, exempt.

There is no liability to pay the FTT if there is no link between the economic substance of the transaction and the FTT-zone, however, uncertainty remains in the proposal as to what exactly this means.

What happens next?

Deliberations at EU level will now take place but it is a moot point as to whether the enhanced cooperation procedure permits the proposal to be substantially amended. All Member States may participate in those deliberations. The proposal for the FTT must be adopted unanimously but only the Member States taking part in enhanced cooperation are allowed to vote.

The extraterritorial nature of the FTT is already attracting a high degree of criticism. The provisions were included deliberately to strengthen anti-avoidance of taxation and to meet a perceived danger of transfers of business outside the FTT-zone but they are badly designed and drafted. There are legitimate legal concerns as to whether the proposal respects the enhanced cooperation procedure and the internal market of the EU. There are political concerns about the precedent that could be set for a two-tier EU and the damage that could be done to international tax cooperation. There are also practical concerns about enforceability. Finally, there are significant economic concerns focusing on whether a FTT is more detrimental than beneficial as it will lead to double/multiple taxation, could distort competition and could increase the burden on banks at a time when global markets remain fragile. There is a recognised argument that a FTT will reduce liquidity and investment and thus damage the real economy, business and investors. One of the objectives of the FTT appears to be punitive – to ensure that financial institutions "make a fair and substantial contribution" to the cost of the financial crisis – yet, putting aside the issue of culpability, this assumes both that financial institutions will be able and willing to absorb the FTT and that the revenue raised by the tax outweighs its detrimental effect.

Recommendation

Given that the intention is for the FTT to come into force on 1 January 2014, you should consider the effect that the FTT could have on your business so that you can then consider issues such as what steps you can take to limit your exposure to the FTT, how you could absorb or pass on the FTT and what new systems and procedures you will need to put in place.

If you wish to have input into the scope of the FTT, you should consider lobbying EU Member States, including the governments of both the participating and non-participating countries. You will need to consider objective arguments against the FTT and present them as soon as possible as deliberations will start imminently. The positions taken by the non-participating EU countries will be influenced in large part by your judgments on how exposed your sectors and economies will be to the FTT via its extraterritorial provisions. The new impact assessment (also dated 14 February 2013) has clearly been constrained by the lack of public data and, accordingly, the non-participating countries are likely to welcome better information on the likely geographical incidence of the tax.

Finally, you may wish to consider your legal position. There are significant legal concerns as to whether the procedure for enhanced cooperation has been met and whether the proposal satisfies the required internal market objective or actually undermines the free movement of capital. It would be possible for natural and legal persons to challenge the FTT directive after it has been adopted if they can show that it "is of direct and individual concern to them" before the Court of Justice of the EU. It is also possible in some circumstances for trade associations to bring a challenge. There is an extremely tight timescale for challenge which cannot be extended (two months from the publication of the legislative act in the Official Journal[3]) and there is case law which states that if a person has standing to challenge a legislative act, has knowledge of it and of its being of direct and individual concern to him but does not challenge within the time-limit, that act becomes definitive against him and he cannot later challenge the legality of that act – even in proceedings before the national courts of the countries which implement that decision.

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3 The action would be brought before the General Court for annulment under Article 263 of the Treaty on the Functioning of the EU. The Court's Rules of Procedure extend the 2-month time limit slightly by adding an extra 14 days to make the application where the challenged measure is published (rather than notified) and 10 days are also added "on account of distance".

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