A TURNING POINT FOR FINANCIAL INSTITUTIONS: A TAX ON TRANSACTIONS

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OVERVIEW

The year 2008 was arguably a turning point for the financial services sector. In Europe, a common political reaction to the financial crisis was that the financial sector should be held accountable and made to contribute financially to the costs of fixing the economic problems it was said to have helped cause.

European Union (EU) legislators were tasked to create an environment in which the financial sector would contribute more fairly to the costs of the crisis and thus address the perceived fiscal imbalance in Europe. Consequently, in September 2011 the European Commission (the Commission) issued a proposal for a EC – directive for a common system of a tax on transactions across all 27 European Union Member States (FTT directive). With the primary political will of getting Financial Institutions (FIs) to contribute their fair share, the Commission's proposals were ostensibly aimed at harmonising taxation of financial transactions, avoiding single market fragmentation and encouraging the financial sector to engage in responsible activities.

By the autumn of 2012, it was clear that the unanimous agreement required from all 27 EU Member States would not be achieved. Eleven Member States (Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain) wrote to the Commission to request an alternative approach to introduce a Financial Transaction Tax only within their territories. These Member States now known as the EU FTT Area, invoked the little-used Enhanced Cooperation Procedure (ECP). The ECP whose detailed provisions are set out in Article 20 of the Treaty on European Union and Articles 326 – 334 of the Treaty on the Functioning of the European Union, is available where a group of at least nine Member States want to move ahead with a Commission initiative, when it has proven otherwise impossible to reach unanimous agreement. As well as consenting the 11 participating Member States on 22 January 2013, there were other important hurdles to negotiate, such as ensuring the proposed FTT directive neither undermines nor distorts competition within the internal market and that it respects the rights, competency, and obligations of the non-participating Member States. As this is a rarely employed procedure particularly in the field of tax for which it is the first time, there are significant legal uncertainties about the validity of the proposed FTT directive and whether the current process meets the requirements set out in the relevant EU Treaties.

The subsequent proposed FTT directive presented by the Commission on 14 February 2013 is being discussed and reviewed technically by all EU Member States at successive Council Working Groups. Although all EU Member States can participate in the discussions, with the potential for other Member States to join the EU FTT Area as discussions proceed, the final wording of the proposed FTT directive requires the unanimous agreement of the 11 participating Member States to become law. The participating Member States would then be required to transpose the proposed FTT directive into their domestic legislation. The transposition window has opened, but since there remains a difference of opinion between the 11 participating Member States on the revised scope of the FTT directive, the effective date of 1 January 2014 to comply with the proposed FTT directive is likely not be achieved.

ELEVEN MEMBER STATES REQUESTED AN ENHANCED COOPERATION PROCEDURE INSTRUMENT IN SCOPE:

– equities
– bonds
– non-spot foreign exchange
– derivatives

This is perhaps to be expected given the detailed concerns on the economic impact of the tax that has been expressed not just by the financial sector but by all sides in the debate from economists and market observers to mainstream business, governments and regulators. Most commentators believe the future scope of the proposal and likely transposition date will become much clearer following the German Federal election which was on 22 September 2013 and the Council's opinion on the viability of the directive.

OUTLINE OF FINANCIAL TRANSACTION TAX – THE ENHANCED COOPERATION PROPOSAL

Broadly, the revised draft FTT directive proposes an ad valorem tax on transactions involving a wide variety of financial instruments (including equities, bonds, non-spot foreign exchange and derivatives) where:

– a Financial Institution party to the transaction is resident in an EU FTT Area Member State; or
– a Financial Institution is party to a transaction in an instrument issued by an entity in an EU FTT Area Member State

Financial Institution (FI) is widely defined and includes;

– investment firms;
– trading venues
– credit institutions;
– insurance/re-insurance undertakings;
– collective investment vehicles (e.g. UCITS);
– pension funds;
– alternative investment funds; and
– other entities where their trading exceeds 50% of the turnover from trading in financial instruments.

Some points worth noting are that:

– A minimum tax rate 0.1% is proposed for each side of the transaction leg (buy side and sell side) or the notional value on a derivatives contract. Each EU FTT Area State would be free to set its own rate at or above this minimum.
– Each leg of the transaction is separately taxed so the headline minimum (subject to any increased set rates) rate would in fact often equate to 0.2% and 0.02%.
– Trading with a counterparty based in the EU FTT Area or under an EU FTT Area regulatory authorisation would trigger EU FTT Area residency even for a non-EU FI bringing it in scope of the tax.
– The relevant FIs are primarily liable for the FTT, but each party to a transaction is jointly and severally liable if the EU FTT is not paid on time.
– Participating Member States would be required to remove existing domestic FTTs when introducing the EU FTT.

RESIDENCE PRINCIPLE

The FTT directive extends the extra-territorial scope of the FTT considerably, with a residence principle which looks not only at the location of the financial institution's registered seat, permanent address, or branch but catches scenarios where the financial institution is:

– authorised to operate in the jurisdiction by the authorities of that participating Member State as a financial institution; or
– authorised or otherwise entitled to operate, from outside that participating Member State, in respect of transactions within that Member State.

Although in certain circumstances, an exemption is offered where it can be proved there is no direct link between the EU FTT Area and the economic substance of the transaction, the burden of proof is always on the tax payers. Clear rules and unambiguous guidance for market counterparties to cover all scenarios will be potentially difficult to provide but obviously essential to prevent disputes and uncertainty.

The extension in territorial scope has been the source of much debate and controversy and will likely remain an area for further discussion in the coming months.

ISSUANCE PRINCIPLE

The issuance principle applies where a transaction has not otherwise been caught under the residence principle but involves an in-scope instrument issued in an EU FTT Area state. The tax will apply even where two parties are not otherwise established in the EU FTT Area but undertake a financial transaction in respect of a financial instrument issued in the area.

With the interaction of the residence and issuance principles, it becomes less advantageous to relocate activities outside of the EU FTT Area as the tax could not thereby be avoided on EU FTT Area-issued instruments. Two aspects of the issuance principle are at play. The first is to discourage an FI moving its activity from an in-Area legal entity to an out-of-Area legal entity and the second is to protect an in-Area legal entity from competition from an out-Area legal entity.

ANTI-ABUSE RULES

The proposed 2013 directive introduces a number of anti-abuse rules designed to make it more difficult to avoid the tax using artificial arrangements. Specifically it permits the participating Member State to ignore artificial arrangements and look to the economic substance of a transaction. All Member State will be instructed to challenge arrangements where they lack commercial substance or defeat the object, spirit and purpose of the relevant 2013 proposal provisions and where any other purpose of such arrangements appears at most negligible.

There are also specific provisions governing the use of depositary receipts or similar securities. Such securities, where issued outside the EU FTT Area but over EU FTT Area-issued underlying stock, will be treated as taxable on the issuance basis unless it can be demonstrated that the instrument was not issued with the essential purpose of avoiding the FTT on the underlying stock. This again introduces uncertainty and places a difficult burden on a taxpayer in needing to prove that the intentions of an unconnected third party were not for the purpose of avoidance (i.e. needing to prove a negative). The FTT directive suggests that institutions with secondary trading in depositary receipt may replace trading in the underlying stock. How this can be reliably measured at the time trades occur and therefore how it will be possible to prove that a trade was not for the sole purpose of avoiding tax remains unclear.

EXTRA-TERRITORIAL SCOPE:

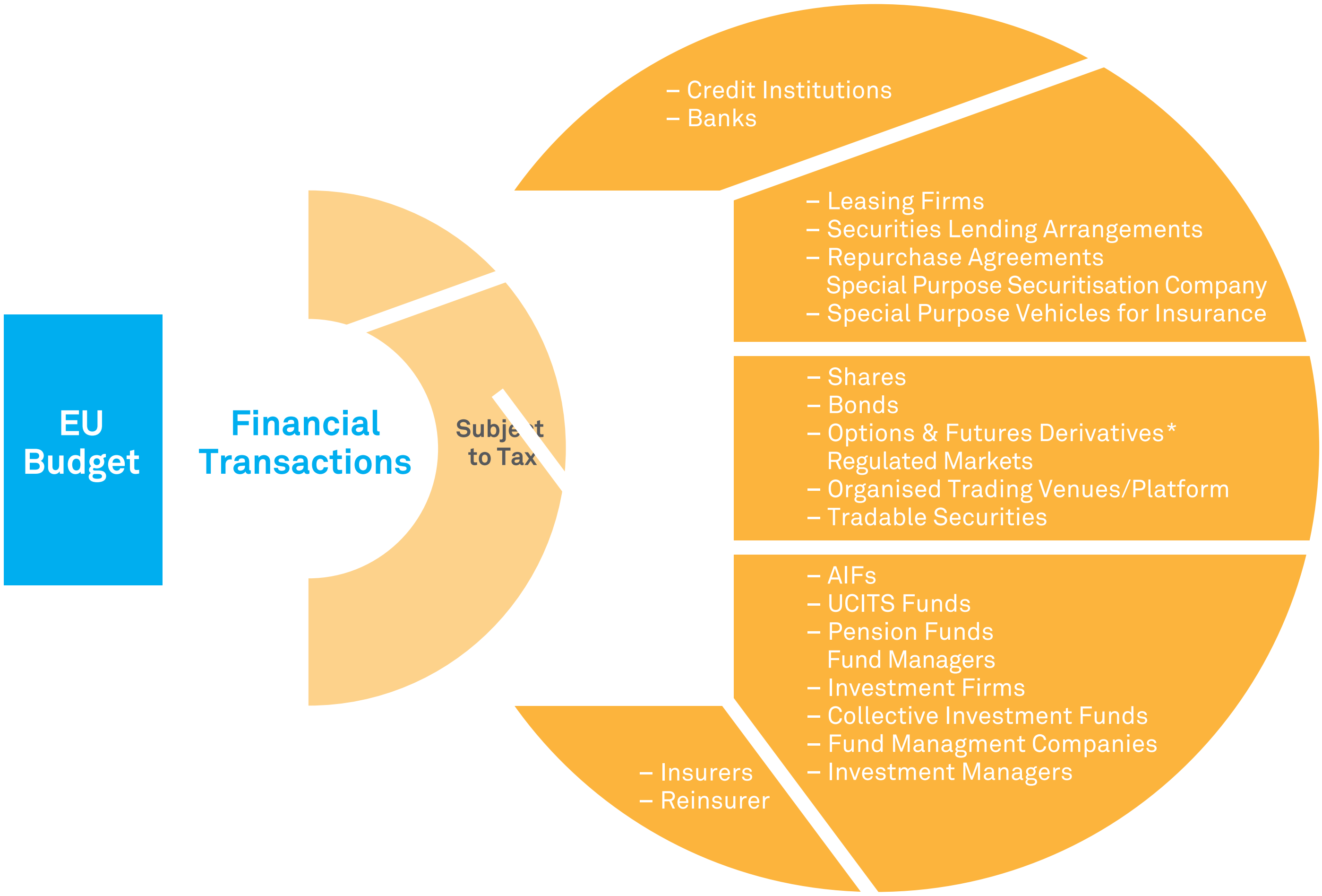
– authorised to operate in the jurisdiction by the authorities of that participating Member State as a financial institution; or
– authorised or otherwise entitled to operate, from outside that participating Member State, in respect of transactions within that Member State

IN-SCOPE TRANSACTIONS, FINANCIAL INSTITUTIONS AND EXEMPTIONS

PROPOSED EXEMPTED INSTITUTIONS
– Central Counterparties (CCPs)
– Central Securities Depositories (CSDs)
– International Central Securities Depositories (ICSDs)

The FTT becomes chargeable for each leg of the financial transaction when it occurs, and although not clearly defined, it is assumed the tax liability will be calculated on the consideration of each purchase and sale of relevant FIs. In a repo, the movement of collateral is incorporated in the "sale" and the "repurchase", and therefore each side of the trade will be taxed, however the industry is lobbying against the imposition of this tax under these circumstances, amongst others. For instance in a repo structure, there could be hundreds of collateral embedded and each of the collateral movements will be taxed under the current proposal.

Caught within the ambit of FIs are:



The diagram covers financial institution where the average annual value of its financial transactions is more than 50% of its overall average net annual turnover. Although it is not specifically in this diagram, self-standing treasury centres of corporates may also pay a FTT

Certain institutions and public bodies are exempt including Central Counterparties (CCPs), Central Securities Depositories (CSDs) and International Central Securities Depositories (ICSDs).

The 2013 proposed directive goes further to include bodies entrusted with managing public debt, such as the:

- European Central Bank
- European Investment Bank
- European Financial Stability Facility
- European Stability Mechanism

Some entities may be involved in the collection and administration of the tax for certain instruments and transactions, in which case, they may be jointly and severally liable for their counterparty's tax liability.

EXEMPT TRANSACTIONS

According to the proposed directive the following transactions are exempt from taxes, these include:

- primary market transactions including the issuance, allotting and underwriting of or subscription for shares or bonds
- most consumer products such as insurance contracts, mortgage lending, consumer credit, enterprise loans, payment services
- spot foreign exchange transactions
- emissions credits and physical commodities transactions
- transactions constituting part of certain corporate re-organisations or restructuring
- transactions with the Central Banks of Member States, the European Central Bank and international bodies that are recognised as such by the host state in which the transaction occurs

PAYMENT RESPONSIBILITY

Payment of the FTT depends on where the financial instrument was issued such as the country of incorporation of the relevant security, as well as the location, corporate structure and regulatory status of the counterparties to the transaction. Additionally, the draft proposed directive imposes joint and several liabilities on each party to a transaction where the FTT due has not been paid within the time limits set out in the draft proposed directive.

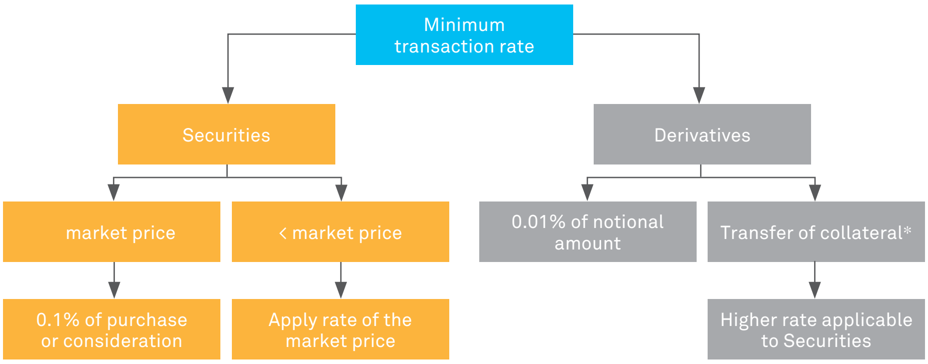
TRANSACTION PARTY	TAX LIABILITY (FTT)	TAX RATE
FI (as agent / principal)	Pays Tax	As determined by the EU FTT Area state
Non-FI	Jointly and severally liable for tax of its counterparty	
Non-EU FI	The non-EU FI is deemed resident in the EU FTT Area state, if its client or counterparty really is resident in that state. The tax is due at the rate set by the EU FTT Area State. Joint and several liabilities apply.	
Multiple FIs	Each party to the transaction has joint and several liability	

RATES

The draft outlines a minimum rate for the FTT however each FTT Area Member State will be allowed to set their rates above the minimum.

– **Derivatives contracts**: 0.01 percent of the underlying nominal (notional value) or the face value used to calculate the payments on the derivatives contract at the time of the financial transaction.
– **Securities transactions**: 0.1 percent of the consideration or market value, if higher.

FTT RATE
– 0.1% of the transaction value per leg of a security
– 0.01% of the notional value on a derivatives contract
– Each leg is separately taxed, the headline minimum rate would equate to 0.2% and 0.02%



* Repos and stock loans will be taxed. The only exception is where there is a movement of the collateral, for instance when a repo is behind a stock loan. The movement itself may not be taxed, this is the same as with a derivatives trade. The derivatives will be taxed but the collateral that is supplied to the CCP during the life of the contact may not.

In a case where the transaction is structured as either a debt security or a loan with a related swap, the two constructs will results in the same economic outcome however they will attract different FTT rates. For instance, in the swap structure, the FI will pay a minimum of 0.01% but if there is a hedge the rate will be 0.1%. The debt security will be taxed at 0.1%. In the absence of a market-marker exemption, the conventional bid-offer will, at the least have to widen to reflect the two legs of the tax.

REVENUE COLLECTION PROCESS

Although the EU regulator permits the participating Member States to adopt the directive into their legislation implemented acts and provide for a uniform method for tax collection, each EU FTT Area state will be required to set out its own registration, collection and reporting requirements. The tax is due at time of execution of the transaction. If processed electronically, the tax will be immediately payable before netting and settlement, with recognition that transactions executed manually cannot be paid immediately but are still chargeable at the moment the transaction occurs. Failure by the FIs to pay the FTT within the applicable time limit will trigger potential interest and penalties as well as allowing the tax authorities to call on the joint and several liability of all relevant parties where applicable.

FTT returns should be sent to the relevant national tax authorities by the tenth day of the month following the month during which the FTT became chargeable. Each participating Member State will be responsible for setting up its own system and procedures.

POTENTIAL IMPACTS

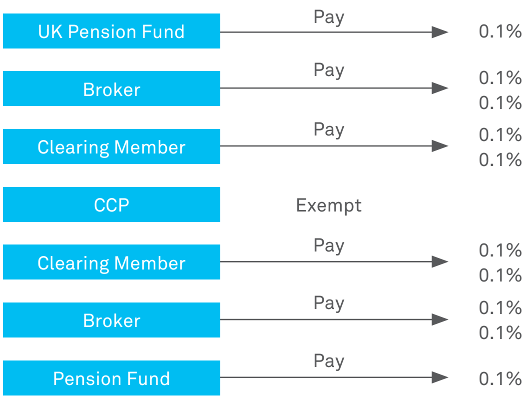
A continuing stream of observations, news articles, and comment letters from all quarters signals that many aspects of the draft directive continue to cause deep concern amongst business and Governments alike. Investors and participants in the financial services sector will need to consider the implications the tax, in its eventual form, may have on existing operations. There may also be a significant impact on the EU economy in general. As a minimum, the FTT directive will require implementation of systems that allow for the application, collection, reporting as well as accounting for the FTT.

Key areas of ongoing industry and government debate include the cascade effect, the impact on existing and new transactions as well as macro-economic dynamics.

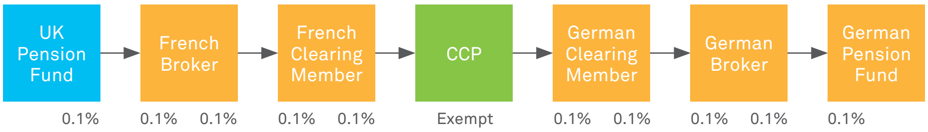
THE CASCADE EFFECT

The current EU FTT proposal places the payment burden on each FIs that is party to the transaction, it applies to both sides of a single transaction and is chargeable on a gross basis before any netting. The lack of intermediary exemptions (e.g. market maker exemption) results in a cascading effect increasing the overall effective rate of the FTT on a transaction proposed will be significantly higher than the 0.1% headline rate applicable to each leg of in-scope transactions.

This may be compounded by regulatory rules such as the European Market Infrastructure Regulation (EMIR) which require a derivatives transaction to be cleared through a Central Counterparty (CCP). Where the FIs is not itself a member of the relevant clearing or settlement system, then its transaction with a clearing member entity thanks to the cascade effect could potentially give rise to multiple FTT charges on what is economically a single trade.



In the example below, the tax is due from six different parties to the transaction except the CCP and payable to two different participating Member States (in this case to Germany and to France) depending on the relevant tax authority of the entity. For instance, the French entities pay tax only to the French authorities and the German entity to its own German authority. Any underlying transaction by the FIs requires a tax to be paid unless the FIs is acting as agent, the CCP is exempt. This multiplies the operational complexity of collecting the FTT as there is not just one party in the chain paying the tax, as is generally true for any tax and stamp duty regimes currently in place within the EU. Institutions who are a party to the transaction will incur significant costs to develop the systems necessary for reporting and payments to the FI's tax authority. The relevant tax authority will need to have their system linked to collect the tax. This will make it extremely difficult to track and validate that the tax has been properly accounted for.



With limited exemptions most investors in cross border securities will be impacted, for instance, pension funds and investors in collective investment vehicles. As well as instances of double taxation (for instance FTT on purchasing units in a collective investment scheme as well as on the scheme's own underlying trades) more generally the FTT charge compounded by the cascade effect outlined above threatens a considerable impact on investment returns generally.

IMPACT ON EXISTING TRANSACTIONS

As mentioned earlier the residence and issuance principles are drawn widely, to bring non-EU FTT Area FIs into scope by reference to the securities being traded or the location of their counterparty.

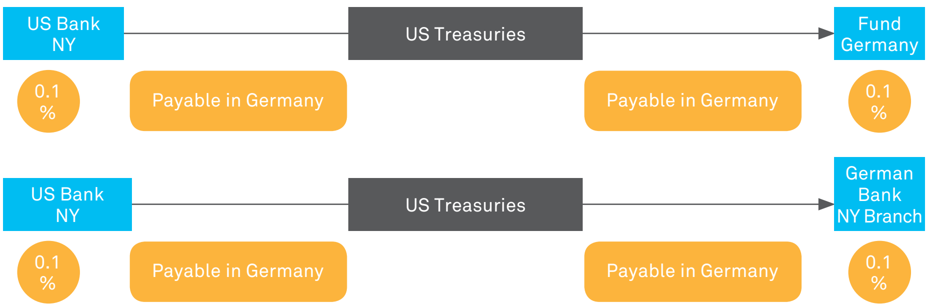
CASCADE EFFECT
- CCPs are exempted from FTT
- FTT applies to FIs that are party to transaction

Let us consider the following examples:

- a French Bank trades Greek securities with an Italian asset manager - the French bank is liable in France and the asset manager is liable in Italy, the residence principle here takes precedence over the issuance principle
- a Spanish bank buys US treasuries from a US hedge fund - the Spanish bank and the hedge fund are both liable to pay the tax in one jurisdiction, Spain.
- a South African bank sells bonds in a French company to a US bank in New York the issuance principle applies, and both banks are liable to pay the tax in France.

The diagram below explains the sequence of events of a typical trade flow.

Sale of security from US to Germany and to a German Bank in NY

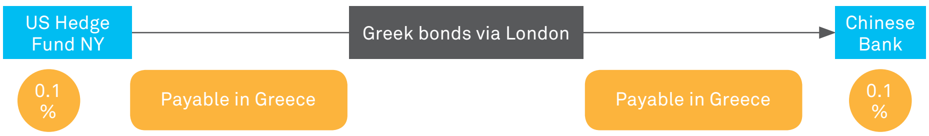


NOTE: FIs outside the EU FTT Area but dealing with the EU FTT Area are directly subject to the FTT

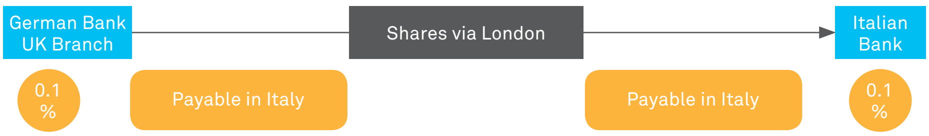
Examples of more complex nature:

– A bank established in France enters into a swap-agreement with a bank established in Switzerland - FTT is due twice in France at national rate, by the Swiss bank as it is deemed established in France and the French bank itself.
– An American bank sells a derivative using a UK investment bank as agent on a French trading platform to a German regional authority. The UK investment bank acts for the account of the German regional authority but is also the buyer and seller - FTT is due twice in Germany at the German rate as both banks are deemed to be established in Germany. If the UK bank using the French trading platform was deemed to be established in France, then the tax would be paid in France.
– A bank established in France lends overnight EUR 10m to a bank in Italy (possibly backed up by securities as collateral). No FTT is due as outright lending and borrowing is out of scope of the FTT, although the collateral may be caught unless the same stock is returned.
– A bank established in France buys overnight EUR 10m of French government bonds from a bank established in Italy and sells them back the next day (repo transaction) - FTT is due both in France and in Italy.
– A bank established in France lends shares (with a market value of EUR 10 million) of an Italian listed-stock company to a bank in Italy. In accordance with the agreement, the shares are returned to the lender after three months. The lending fee is EUR 10,000 - FTT is due both in France and Italy.

Sale of security more examples – *illustrative*



FIs outside the EU FTT Area and FIs not located within EU FTT Area but ISIN is issued within Europe, the FIs are directly subject to the FTT.



The FTT is still payable in Italy for both parties.

IMPACT ON OTHER FINANCIAL TRANSACTIONS

Existing national FTTs enacted in participating EU FTT Area countries will continue to apply until the FTT directive comes into force, at which time participating states would be required to cease imposing similar transaction tax regimes. However, existing transaction taxes or stamp taxes applicable in non-participating FTT Member States could continue giving concern that potential double taxation may occur. This is possible in cases such as where a financial institution located in an EU FTT Area purchases shares originally issued by a UK listed company, the transaction will be subject to both EU FTT and UK Stamp Duty.

MACROECONOMIC IMPACT

A large number of critics across the industry, the market and regulatory infrastructure, have raised concerns that the FTT may have an adverse impact on the real economy of the participating states due to potential market disruption, as explained above. There is fear that gross domestic product (GDP) may stagnate and growth could shrink if a tax is imposed. This impact of this could likely to be felt beyond the FTT Zone Area.

FTT would particularly hit overnight repos, which over time may become uneconomic. This is due to the maturity transformation effect of buying and selling the repo over a day. If an overnight repo carried out each day over a 250-day business year, the total FTT charge would be in total 50% of the notional value for both FIs. Taking a 100m Euro repo, 4 years of FTT would have eroded during the entire value of the bonds. Money market funds meet short-term cash needs and help maintain stability through investments in short-term securities. These instruments have a high portfolio turnover and given the current low interest rate environment, operate on very thin margins. A gross cascading FTT would likely increase costs to the point of making many such funds unviable. The EU FTT could thus affect general liquidity with a consequent reduction in the supply of short-term credit.

A tax may lead to a contraction in the market due to an increase in the cost of trading european bonds. The repo and lending markets provide cost effective and secure financing in the form of commercial paper and other non-bank lending. If alternative sources of funding are unavailable, it may become more difficult and costly for FIs and corporations to raise adequate working and investment capital, and the cost of sovereign debt issuance could also be higher. This may undermine collateral efficiency, and impede liquidity in the market with impacts on investors and the markets. There are other areas that could be affected such as market infrastructure which we can cover in another paper.

PRE-IMPLEMENTATION NEGOTIATIONS

The view which has been frequently expressed is limiting the tax to just the EU FTT Area may have far reaching consequences given certain FI's could easily migrate their operations outside the EU FTT Area to regions where the tax may not apply with a consequence impact on the tax revenue and the economies of the EU FTT Area.

Influential participants in the financial markets have also made their views known over the costs and the destabilising effects it could have. As reported in Reuters in May 2013, Remco Lenterman, chairman of the FIA European Principal Traders Association, said "I would be astounded if it passes in its current form". Some commentators are advocating a more straightforward sales tax on banks. Daniel Gros, the head of the Centre for European Policy Studies, a Brussels think-tank, is one of them, as he was quoted in the Daily Times on 31 May 2013, saying "As it is designed right now, it doesn't make sense." It is possible that when the final directive is complete by end of 2013, and if there is a speedy transposition into national law by the participating Member States, this common framework for an FTT could still enter into force towards the middle of 2014. It must be noted that the final scope of the FTT may be different.

The proposed FTT directive continues to cause much concern among non-participating Member States with the UK, supported publicly by Luxembourg lodging a legal challenge at the Court of Justice of the European Union, concerned about the extra-territorial aspects of the Commission's proposal. Whilst the very ambitious timescale proposed for implementing the FTT Enhanced Cooperation Procedure will most likely not be met, there is still strong support from some quarters to bring a final version of the FTT directive into force as soon as possible. On the 3 July 2013, the European Parliament voted to adopt the FTT directive with some suggested alterations.

Negotiations at EU Council level on the EU Legal Opinion seem to be moving slowly. However, as the Member States work to understand the practical impact of the proposed terms of the FTT directive for the EU FTT Area with some apparently identifying red-line changes they wish made if they are to vote in favour. Within the group of 11 participating Member States, there are reported to be key disagreements over aspects of the proposal. Whilst Italy and France have implemented national FTTs, they are publicly unsure about widening the tax beyond shares to government debt amid fears it may discourage investors from buying their bonds. An exemption for pension funds has also been proposed as a necessary amendment.

Once the FTT directive does come into effect, each participating Member State would be required to modify its domestic legislation to bring it in line with the wider FTT regime. As most commentators now expect that the introduction of the FTT will either be delayed or introduced in phases. Some consideration should be given to the scope and timing and to the possibility that if an EU vacuum subsists for too long, we may see more domestic FTTs being introduced as temporary revenue-raising measures prior to the FTT coming into force.

For more information, please consult the press releases on proposal for FTT and challenges in EU tax policies or visit the European Commission's link to Financial Transaction Tax.

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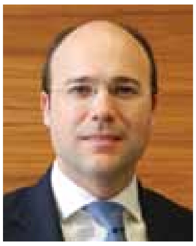

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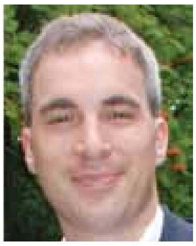

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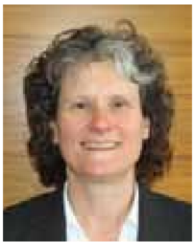

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