CLIENT MEMORANDUM

Latest Developments Regarding the Proposed European Union Financial Transaction Tax

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Despite difficulties in reaching agreement on the detailed terms, there is still political momentum for the introduction of a financial transaction tax (**FTT**) amongst at least 10 European Union (**EU**) Member States, including France and Germany. The United Kingdom's attempt to derail the proposal at an early stage, via a legal challenge, was dismissed on 30 April 2014. The current plan of the participating Member States is to work on a progressive implementation of the FTT, commencing on 1 January 2016.

History

Following the failure to secure unanimous support from EU Member States for the introduction of an EU-wide FTT, certain Member States requested permission to establish enhanced cooperation between themselves in the area of an FTT. The EU Council adopted a decision on 22 January 2013 authorising such cooperation (the **Decision**).

At that stage, 11 countries (but excluding, in particular, the United Kingdom, Ireland and Luxembourg) indicated an intention to participate: namely, France, Germany, Italy, Spain, Austria, Belgium, Estonia, Greece, Portugal, Slovakia and Slovenia.

Further to the Decision, on 14 February 2013, the EU Commission published a proposal for a directive (COM/2013/71) (the **Revised Draft Directive**) for a common FTT in those EU Member States which choose to participate (the **FTT Zone**).

Goals

The stated aims are to raise revenue, ensure that the financial services sector bears its fair share of the overall tax burden, discourage undesirable market behaviour and improve the internal market within the EU by harmonisation of the features of an FTT.

Scope

According to the Revised Draft Directive, the proposed FTT has wide scope and would apply to financial transactions where at least one party to the transaction is established in the FTT Zone and either that party or another party is a financial institution established in the FTT Zone. Some key features of the proposed tax include the following:-

- “Financial institution” covers a wide range of entities, including insurance (both life and general insurers) and reinsurance companies, banks, collective investment funds, pension funds, securitisation special purpose vehicles and any other body or person if the average annual value of its financial transactions constitutes more than 50% of its overall average net annual turnover. It is irrelevant whether the financial institution is acting as principal or agent;

- “Financial transaction” includes the sale and purchase (including intra-group transfers and exchanges) of a financial instrument (before netting or settlement), a transfer of risk associated with a financial instrument and the conclusion of a derivative. Primary market transactions, such as the issue of shares or bonds or units in a collective investment fund, are excluded and so are restructuring operations; and transactions not involving a security, such as entry into an insurance contract or the making of a syndicated loan, are outside the scope. However, the provision of collateral in the form of securities, the transfer of legal title to securities to a custodian, the redemption of shares, repos and stock-lending are apparently included; and there is a cascade effect where a single commercial transaction involves multiple legs, for example via brokers and members of a clearing system;

- The proposed minimum rate of tax is 0.1% of the consideration (or market value, if higher), or 0.01% of the notional amount in relation to a derivative; and where both parties to a financial transaction are a financial institution, there is a double tax charge, on both the “buy” side and the “sell” side;

- There are two anti-abuse rules; a general “substance over form” principle applies where an artificial arrangement is put in place which has an essential purpose of avoiding taxation or which defeats the object, spirit and purpose of the law, and the arrangement leads to a tax benefit; in addition, a specific rule deems depositary receipts issued with the essential purpose of avoiding tax on transactions in an underlying security issued in the FTT Zone as themselves issued in the FTT Zone, which potentially catches, for example, ADRs issued in respect of shares in a French company.

Extraterritoriality

Compared with earlier proposals, the Revised Draft Directive contained an important widening of the geographical reach of the proposed tax, with regard to the meaning of the term “established” in the FTT Zone.

This includes, as might be expected, entities which are actually regulated or formed in a participating Member State or which are carrying on business through a branch in a participating Member State or are authorised in a non-participating Member State and on that basis are engaged in financial transactions in a participating Member State (via the EU “passporting” arrangements). So, for example, if the French branch of an Irish bank sells Japanese corporate bonds, the transaction is within the scope of the FTT.

However, in addition, a financial institution which has no business presence in the FTT Zone but which is party to a transaction where the counterparty is “established” (by reason of authorisation, formation or branch business) in the FTT Zone (“the counterparty principle”), or where the underlying financial instrument (other than a derivative which is not traded on an organised platform) was issued in the FTT Zone (“the issuance principle”), is deemed to be established in the FTT Zone. Accordingly, if a Bermudian insurer sells shares in a Dutch company to an Italian buyer, the Bermudian insurer will, in principle, be deemed to be established in Italy and, therefore, within the FTT Zone. Even more controversially, if a Cayman Island fund enters into a repo with a U.S. bank in respect of shares in a German company, both the Cayman Island fund and the U.S. bank will, in principle, be deemed to be established in Germany, and therefore within the FTT Zone.

The breadth of scope is intended to pre-empt efforts by financial institutions, which wish to service the FTT Zone, to avoid FTT by relocating transactions outside the FFT Zone. However, it raises difficult enforcement questions.

The broad theoretical scope is tempered by a rule that where the person liable for payment of FTT proves that there is no link between the economic substance of the transaction and the FTT Zone, a party will not be deemed to be established in the FTT Zone. However, it is very unclear at the moment how generously this exception would be interpreted or what supporting evidence would be needed.

Commercial impact

As currently formulated, the introduction of an FTT could impose material costs on the financial services sector.

In addition, the terms of financial transactions will need to allocate responsibility for the tax contractually, given that the legislation is likely to impose primary liability on any financial institution which is party to the transaction (on both the buy and sell side) and, in the event of default, joint and several secondary liability on all participants.

Detailed collection and enforcement mechanisms have not yet been developed but it is possible that service providers, such as exchanges and clearing systems, will be made liable for FTT; in which case their operating terms will need to be amended to include indemnities from relevant market participants.

United Kingdom legal challenge to the Decision – 30 April 2014

The United Kingdom brought a legal challenge to the Decision before the European Court of Justice (**ECJ**), claiming that the extraterritorial reach of the proposed FTT, and specifically the "counterparty principle" and the "issuance principle", breached both EU and customary international law, by encroaching on the sovereign competency of non-participating Member States. The United Kingdom also claimed that the implementation of an FTT would impose costs on non-participating Member States in providing assistance in the recovery of FTT, under the EU mutual assistance and administrative cooperation directives.

On 30 April 2014, the ECJ rejected both claims, essentially on the grounds that they did not relate to the Decision itself, which simply authorised enhanced cooperation between the requesting Member States. In other words, the claims were premature because they related to the proposed substantive provisions of an FTT regime.

However, the ECJ noted that a challenge could be raised at a later stage once a measure has been adopted for the purposes of implementing an FTT and all the details of the tax have been definitively established.

*Economic and Finance Ministers (**ECOFIN**) council meeting – 6 May 2014*

In any case, it is currently unclear whether and, if so, in what form, an FTT might be adopted.

It is still subject to negotiation between those Member States which choose to participate. More than a year after the original intended implementation date, the relevant countries have not reached agreement. According to a note on the current state of play issued by the President of the EU Council on 2 May 2014, they continue to work on the details of the design of the tax and the interaction with EU financial regulatory developments and the monetary policy of the Euro system.

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Continued

The FTT was discussed at a meeting of the ECOFIN Council on 6 May 2014. Some EU Member States, including Sweden, Luxembourg and the United Kingdom, and industry representatives repeated their concerns about the adverse impact of an FTT on the European economy, in both participating and non-participating countries.

Ten of the 11 jurisdictions which originally backed the proposal (excluding Slovenia) issued a joint press release following the ECOFIN meeting confirming their commitment to the FTT project. The current plan is to work on a progressive implementation of the FTT, focusing initially on a limited form of FTT – the taxation of shares and some derivatives (presumably equity derivatives). So, fixed-income products, for example, would not be taxed initially. There has also been a suggestion that the minimum rate of tax might be lower than originally proposed – namely 0.01% instead of 0.1%.

The proposed start date for the first phase of an FTT regime is now 1 January 2016 at the latest.

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