On 14 February 2013 the European Commission published a revised proposal and a draft Council Directive implementing an EU financial transaction tax ("FTT"). Whilst the revised proposal envisages "enhanced cooperation" between eleven1 of the twenty-seven EU Member States (and so ostensibly has a smaller geographical reach than the 2011 proposal), the current proposal has implications for the UK and, indeed, the worldwide financial sector.

This paper outlines the background to the FTT, including its nature and scope, and identifies some possible implications for the UK and the next steps.

A ROBIN HOOD TAX: POLICY

The FTT’s origins lie in the global economic and financial crisis. In accordance with the “polluter pays” principle, the proposed FTT seeks to ensure that the financial sector:

- makes a fair and substantial contribution to the costs of the crisis
- is taxed fairly as compared to other sectors, and
- is dis-incentivised from pursuing activities with excessive risk.

The FTT also seeks to harmonise financial transaction tax measures so far as is needed “to ensure the proper functioning of the internal market for transactions in financial instruments and to avoid distortion of competition.” It would replace national measures, such as France’s financial transaction tax, with a co-ordinated regime.

RECAP: APPLICATION OF THE FTT

The FTT will apply to all transactions involving financial instruments (such as shares and bonds) where:

- at least one party to the transaction (or the issuer of the underlying securities) is established in the FTT zone, and
- at least one financial institution is a party (either acting for its own account, for the account of another person, or acting in the name of a party to the transaction).

1 Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia
Broadly, the FTT applies a minimum rate of:

- 0.01 per cent. on derivative transactions (based on the highest notional amount identified), and
- 0.1 per cent. on other transactions such as transactions in shares and bonds (based on the higher of the consideration and the market price).

Since, however, FTT is imposed on a gross basis on each stage of a transaction (with no equivalent to VAT input tax recovery), the effective rate will be significantly higher than the headline rate (the "cascading" effect).

WHO PAYS FTT?

Each relevant financial institution pays FTT to the tax authority of the participating Member State in which it is deemed to be established. FTT could therefore be payable by any or all parties to a transaction.

Certain entities and transactions are specifically excluded from its scope, such as transactions with the European Central Bank, restructuring operations, primary market transactions, and day-to-day activities of citizens and businesses. There is, however, no exemption for pension funds.

FTT becomes chargeable the moment the transaction occurs (regardless of subsequent cancellation).

THE CURRENT POSITION: ENHANCED COOPERATION

The initial proposal, published on 28 September 2011, was for a common system of FTT across the EU. It became clear, however, that there were fundamental differences of opinion among Member States as to the need for an FTT and that unanimous support for the principle would not be obtained in the foreseeable future. Consequently, on the request of eleven Member States, a proposal for authorising "enhanced cooperation" in the area of FTT was submitted to the Council. The Parliament’s consent was given on 12 December 2012, and the authorisation of the Council followed on 22 January 2013. The current draft Directive is based closely on the 2011 proposal, but is proposed in the context of enhanced cooperation.

TERRITORIALITY

The scope of FTT is stated to be confined to the FTT zone: to apply, there must be a link with one of the participating Member States. The test is primarily one of "establishment". This was always a broad concept – including, for example, the worldwide branches of a financial institution established in the FTT zone.

For example, a financial institution will be deemed to be established in a participating Member State if it is party to a transaction with another financial institution or party which is established in that participating Member State. This, of course, means that a UK bank could be deemed to be established in France (and thereby subject to the FTT at the French rate) by virtue of being party to a transaction with a bank that has its registered seat in France.
Furthermore, the draft Directive incorporates an additional feature which operates to give the FTT an even broader extra-territorial effect: the “issuance” principle. A financial institution, or indeed any party, will be deemed established in a participating Member State if the transaction involves a financial instrument issued within that Member State (with some exceptions). This means that a US and UK bank could find themselves subject to the FTT at the German rate by virtue of their transaction involving bonds issued in Germany.

A waterfall principle is incorporated into the test. This is designed to avoid a conflict arising where more than one participating Member State is relevant (whether by residence or under the issuance principle). For example, if a UK bank enters into a transaction involving Spanish shares with an Italian individual, the UK bank would pay FTT to Italy (at the Italian rate).

The issuance principle was introduced to provide a safeguard against avoidance of the tax; it attempts to allay concerns among the eleven participating Member States that enhanced cooperation in the area of FTT should not result in evasive actions, distortions and transfers to other jurisdictions. It was feared that countries outside the FTT zone would obtain a competitive advantage.
The only way of rebutting the deemed establishment principle rests on demonstrating that there is no link between the economic substance of the transaction and the FTT zone. No guidance is given in the explanatory memorandum to the proposal as to how this test would be applied.

ANALYSIS

The features providing for extra-territorial effect and, in particular, the issuance principle, have proved highly controversial, both as a matter of principle and out of fears for the prejudicial effect on non-participating Member States.

From a legal perspective, the enhanced cooperation procedure must fulfil preconditions in the EU treaties, including:

• it must not undermine the internal market or economic, social and territorial cohesion, must not constitute a barrier to or discrimination in trade between Member States, and must not distort competition between them, and

• it must respect the competences, rights and obligations of non-participating Member States.

The Council Decision of 22 January 2013 authorising enhanced cooperation in the area of FTT found that the enhanced cooperation complies with the treaties and with EU law and, in particular, satisfies the two conditions set out above. There is, however, considerable uncertainty as to whether the proposal will comply with EU law.

Most important perhaps, from a UK perspective, are the following concerns:

• **Prejudicial impact on non-participating countries.** The issuance principle raises the prospect of transactions between parties in non-participating countries worldwide being within the scope of the FTT. The carve-out for transactions without a sufficient link to the FTT zone cannot provide reassurance in the absence of any detail as to what this might involve. If UK parties are then treated as established in a Member State within the FTT zone (whether in consequence of the issuance principle or the wide meaning given to establishment for this purpose) there is also potential for double taxation if the UK already applies stamp duty or SDRT to transactions falling within the FTT.

• **Distortion of competition:** Application of the FTT could depend on whether a counterparty is established in London or Paris. Furthermore, if the participating Member States choose to impose different rates of FTT (subject to the minimum rates set out in the draft Directive), and the transaction involves securities issued in the FTT zone, it may be more attractive to choose a counterparty with a lower FTT rate than the Member State in which the securities were issued than to choose a non-FTT zone counterparty.

• **Practicalities and enforceability:** The FTT is likely to impose an administrative, as well as a financial, burden on financial institutions worldwide. There has also been scepticism as to the practical enforceability of the FTT worldwide. The draft Directive goes some way towards addressing this by providing that each party to a transaction will be jointly and severally liable for payment of FTT due by a financial institution if FTT is not paid by the due date.
This, of course, says nothing of the politics at stake: having opposed the FTT proposal in its entirety, the UK could find that the FTT has a significant impact on its financial institutions while the UK Treasury sees none of the benefits.

THE FUTURE

The current, somewhat ambitious, plan is for participating Member States to introduce the FTT from 1 January 2014. Over the next few months the proposal will be negotiated (all Member States may participate in the discussions) and the final wording agreed. Implementation of the Directive requires the approval of at least nine participating Member States. Non-participating Member States are not entitled to vote.

A legal challenge to the FTT in the Court of Justice of the European Union by a Member State such as the UK (or, indeed, once the FTT comes into effect, by any person affected by the FTT in national courts) seems a real possibility. Luxembourg has already stated that it reserves the right to seek all legal remedies available if the FTT spills over into non-participating Member States that could not reach agreement on it at EU level.