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European Commission publishes legislative proposal for a financial transaction tax

On 28 September 2011, the European Commission published its legislative proposal for a Council Directive on a financial transaction tax in the EU. In his annual State of the Union Address in Strasbourg, José Manuel Barroso, the President of the European Commission, commented: *"In the last three years, Member States – I should say taxpayers – have granted aid and provided guarantees of €4.6 trillion to the financial sector. It is time for the financial sector to make a contribution back to society. That is why I am very proud to say that today, the Commission adopted a proposal for the Financial Transaction Tax."*

As proposed, the impact of the tax would be far from uniform across EU Member States and could adversely affect international competitiveness. Indeed, the UK has already expressed its objections to any financial transaction tax applied at a less than global level, and for good reasons. It remains to be seen whether, without the support of the UK and potentially other EU Member States, the legislative proposal will achieve anything beyond keeping the possibility of a financial transaction tax on the policy agenda, in the EU and internationally.

This note provides an overview of the financial transaction tax proposed by the European Commission.

The design of the financial transaction tax

Scope

Broadly speaking, the financial transaction tax would apply to financial transactions in financial instruments, provided that a financial institution established in the territory of a Member State is party to the transaction, whether acting for its own account, for the account of another person or in the name of a party to a transaction.

Determining residence

A financial institution would be deemed to be established in a Member State if (a) it has been authorised by the authorities of that Member State, (b) it has its registered seat there, (c) it is resident there, (d) it has a branch there which carries out the financial transaction or (e) it is party to a financial transaction with a financial institution or other person established there. Even where these criteria are satisfied, a financial institution would not be considered to be established in a Member State if it can be proven that there is no link between the economic substance of the relevant transaction and the territory of any Member State.

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Definition of "financial instrument"

The tax would apply in relation to a wide range of financial instruments, including those covered in the Markets in Financial Instruments Directive (MiFID) 2004/39/EC as well as structured products, and regardless of whether they are traded on regulated markets, multilateral trading facilities or, indeed, over-the-counter. Other instruments, for example loans and loan participations, and many retail products, such as insurance contracts, mortgage lending and consumer credit, would be excluded from the scope of the legislative proposal.

Definition of "financial transaction"

The definition of "financial transaction" is broad and covers the purchase and sale of a financial instrument before netting and settlement (including repurchase and reverse repurchase and securities lending and borrowing agreements), the transfer between entities of a group of the right to dispose of a financial instrument as owner and any equivalent operation implying risk transfer and the conclusion or modification of derivatives agreements.

Although the details are not clear at this stage, it appears that the intention is to subject transactions relating to the issue of notes and other instruments out of securitisations as well as the subsequent trading of these instruments to the financial transaction tax. It also appears that the transfer of underlying assets into a securitisation would not be taxed unless those assets were themselves financial instruments.

For policy reasons, transactions with, for example, the European Central Bank and national central banks would be outside the scope of the tax.

Definition of "financial institution"

The term "financial institution" is defined by way of a long list, including investment firms, organised markets, credit institutions, insurance and reinsurance undertakings, collective investment undertakings and their managers, pension funds and their managers, alternative investment funds and their managers, a securitisation special purpose vehicle and other undertakings carrying out certain activities to a sufficiently significant extent. Central Counter Parties, Central Securities Depositories and International Central Securities Depositories would not be treated as financial institutions for the purposes of the tax.

Taxable amounts and rates

The provisions on taxable amounts and rates draw a distinction between financial transactions which are related to derivatives agreements and those which are not. Transactions related to derivatives agreements would include the conclusion and modification of derivatives agreements. In addition, it would appear that, for example, the delivery of a financial instrument pursuant to a derivatives agreement would be a transaction related to a derivatives agreement.

In relation to financial transactions other than those related to derivatives agreements, the taxable amount would be either the sum payable in return for the transfer or, if higher and in certain other circumstances, the market price. The tax would be set at a minimum level of 0.1%.

In relation to financial transactions related to derivatives agreements, the taxable amount would be the notional amount of the derivatives agreement at the time of the financial transaction. The tax would be set at a minimum of 0.01%.

Member States would be free, in principle, to impose higher financial transaction tax rates.

Persons liable for payment

The financial transactions tax would generally be payable by each financial institution which is party to the transaction, whether in the EU or outside the EU. Where a financial institution acts in the name or for the account of another financial institution, that other financial institution would be liable instead. These arrangements could give rise to multiple tax payments on a single transaction, although each party to the transaction would pay tax at most once.

If a financial institution failed to pay the financial transaction tax it owes within the applicable time limit, each party to the transaction would become jointly and severally liable for the payment of the tax. It would appear therefore that even persons other than financial institutions could become liable for the tax in these circumstances. Further, if financial institutions outside the EU did not pay the tax, their counterparties in the EU might have to pay the tax on their behalf.

Tax collection

The tax would be collected at the moment when a financial transaction occurs if it is carried out electronically. For over-the-counter transactions, the tax would have to be paid within three working days.

Practical impacts

Tax revenues

In its press release, the European Commission indicates that the financial transaction tax could raise approximately €57 billion every year. However, any such estimate is subject to very large margins of uncertainty as the behavioural responses of market participants to a new tax are difficult to quantify.

Impact on competitiveness

The tax rates may appear to be set at a low rate, but would apply to potentially large taxable amounts. And financial institutions would be very conscious of the accumulation of financial transaction tax across their transactions. As the application of the tax depends on the residence of the relevant financial institutions, opting for a residence outside its scope might become more attractive. Indeed, the European Commission's impact assessment considers the possibility of a relocation of securities markets by 10% and a relocation of derivatives instruments of 70% or 90%.

Disproportionate impact on the UK

The UK would be disproportionately affected by a financial transaction tax. Estimates suggest that the vast majority of any financial transaction tax revenue would be raised in the UK. The tax could thus reduce the international competitiveness of London as a financial centre. Of course, as discussed below, the UK may exercise its right of veto to the application of the financial transaction tax on its own territory.

Scope for regulatory arbitrage

Members would have to adopt measures to prevent tax evasion and avoidance. In practice, this could prove a challenge. In particular, regulatory arbitrage between financial activities outside the scope of the tax and within the scope of the tax or between financial transactions related to derivative agreements and those not so related may be a possibility.

The EU legislative process and the prospects of the financial transaction tax

The European Commission proposed that the financial transaction tax should come into force on 1 January 2014.

However, to proceed under Article 113 of the Treaty, the legislative proposal would require unanimous agreement by Member States in the EU Council of Ministers after the European Parliament has given its opinion. And unanimity will not be achieved if the legislative proposal remains in its current form. The UK in particular has expressed opposition to the idea of a financial transaction tax if it is not agreed at a global level.

This raises the question whether it might be possible for a financial transaction tax to be implemented without the UK in the remaining EU countries. Without the UK, however, the revenues that could be raised by means of the tax might be significantly reduced. And other Member States would have cause for concern that the tax could put them at a competitive disadvantage relative to, among other countries, the UK.

In the meantime, the legislative proposal adds uncertainty at a time when firms are already preparing themselves for a raft of financial regulatory changes.

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