European Commission issues new Financial Transaction Tax proposal

On 14 February 2013, the European Commission (EC) presented its draft Directive for a European Union (EU) Financial Transaction Tax (FTT) for 11 participating Member States (PMS). The FTT is proposed to take effect from 1 January 2014. This Alert examines what the FTT means for non-financial sector businesses.

Main considerations

The new EC proposal, closely based on its initial proposal of September 2011, remains a very broad measure, taxing transactions in equities, bonds, fund units and derivatives. The tax will have an impact beyond countries that enact an FTT and beyond the financial sector.

The Directive would affect non-financial sector businesses in two key ways as a result of:

- The broad definition of “financial institutions” – likely to include treasury companies, pension funds, and other non-financial sector companies with a significant average value of financial transactions. Such entities will be directly subject to the tax for transactions with FTT zone parties or in transactions in financial instruments issued in the FTT zone.

- Financial institutions passing on the estimated €35bn (approximately US$45.5bn) annual costs of the tax through higher borrowing and hedging costs, lower returns on pension and investment fund assets and higher energy and commodity costs to consumers, or as a result of joint and several liability provisions of the Directive.
In light of the proposed Directive, corporates will need to:

- Review their banking relationships with FTT zone banks (including London, New York or Singapore branches of FTT zone banks).
- Consider the direct impact of the tax on their treasury or financing vehicles and on pension funds.
- Review terms and conditions of transactions with banks to see where liability for FTT sits, bearing in mind joint and several liability.
- Consider their hedging strategy for interest rate, currency and commodity risks, all taxable if executed with FTT zone counterparties.

Financial institution defined

A non-regulated person will be treated as a financial institution (FI) if the average annual value of its financial transactions is more than 50% of its overall average annual turnover (net of sales rebates and turnover taxes).

For this purpose the value of financial transactions includes the full sale or purchase price for each sale or purchase of equities, bonds or fund units and 10% of the notional principal of any derivative transactions.

Companies affected are likely to include:

- Corporate treasury, holding and potentially operating companies of groups carrying on hedging activities.
- Utility companies, transport undertakings such as airlines and shipping companies, food manufacturers and distributors, and other businesses involved in significant risk management activity, whether this covers FX, interest rate, counterparty credit or commodity price risks.
- Corporate pension funds involved in dealing and managing risks on their investment portfolios, including through repo and stock lending transactions.

Where one FI acts in the name of or for the account of another FI, only that other FI would be liable to pay FTT. This means that corporate treasury and pension companies will be directly liable to report and account for FTT on transactions by banks or brokers carried out on their behalf.

“Residence” basis supplemented by “issuance” basis

The original draft FTT Directive contemplated that the connecting factor for taxing rights would be residence. In other words, the tax would apply to a financial institution resident in the EU, extended to include any other financial institution worldwide transacting with a person (whether or not a financial institution) resident in the EU (the so-called “deemed establishment” rule). It is understood, however, that the “residence” basis was considered by PMS to be insufficient to prevent the relocation of trading activity outside the FTT zone.

The “issuance” basis is, therefore, included as a supplementary basis of taxation. This means that the trading of financial instruments issued in the FTT zone will be subject to FTT, irrespective of where the parties to the transaction are located. For example, the sale by a US bank to a US treasury company of bonds issued by a German company would be subject to EU FTT.

The target scope of the “issuance” basis goes wider than equities, bonds and fund units issued in the PMS to include depositary receipts and exchange traded derivatives issued in the FTT zone. This seems to ignore the fact that an ‘issuance’ basis can only apply to property which can be ‘issued’ and it is not currently clear, therefore, how this will work in the context of derivatives. The inclusion and scope of an “issuance” basis is bound to be controversial, particularly in the UK, US and other markets not taking part in the EU FTT.

Intra-group transactions

Transactions within a group are not excluded from FTT as long as at least one party to the transaction is an FI and either the residence basis or issuance basis applies. Indeed within groups, the tax base is extended to include any transfers of risk associated with financial instruments covered by the Directive, even if such risk transfers are not themselves financial transactions within scope. This would mean, for example, that a parent company's guarantee of
its subsidiaries' derivative positions could be subject to FTT if any of the companies involved are in the FTT zone or the positions involve FTT-issued instruments.

Anti-abuse rule

As well as the anti-abuse measure for depositary receipts mentioned above, the new proposal contains a general anti-abuse rule (GAAR) modelled on the EC’s Recommendation of 6 December 2012 on aggressive tax planning. The GAAR would allow PMS to treat artificial arrangements aimed at avoiding the tax by reference to their economic substance.

Avoidance is defined through an objective test of whether the “object, spirit and purpose” of the tax provisions is defeated. Given the wide-ranging objectives of the FTT as described in the EC’s proposal – which include ensuring that “financial institutions make a fair and substantial contribution to covering the costs of the recent crisis”, and to “create appropriate disincentives for transactions which do not enhance welfare or the efficiency of financial markets” – this anti-abuse measure coupled with the taxation of counterparties outside the PMS will be particularly controversial.

Cost of the tax

Minimum rates are 0.1% for transfers of bonds and shares and 0.01% on the notional value of derivatives. These rates apply to each party to a transaction which is an FI and to each link in a chain of transactions (the cascade effect), except where one FI acts as agent (in the name of or for the account of) another FI.

The directive provides for each party to a transaction (including non-financial institutions) to be jointly and severally liable for unpaid FTT.

As well as the tax charge itself, companies will need to have in place the systems needed to comply with it. The tax is payable on the same day as the liability arises (three days for paper transactions). This will involve separating financial transactions by location and status of counterparty, and by place of issuance of the financial instrument, and having systems to report to, and account to, the tax authorities of the PMS, who may not necessarily set the same rates or procedures for their operation of the tax.

Next steps

Following the EC’s adoption of its revised proposal on 14 February, the draft Directive will now be subject to further discussion and negotiation between all EU Member States (including those that are not part of the PMS group) and the European Parliament will be invited to give its (non-binding) opinion on the proposal.

The non-participating Member States can be expected to press for changes to protect their interests and that of the Single Market as a whole but, to be adopted, the proposal (with or without further amendments) will need the unanimous approval of only the 11 PMS. It remains to be seen how soon they will be ready to give that approval.

Once the Directive is adopted, the PMS will then have to adopt domestic law and administrative provisions to apply the FTT. The draft envisages they do this by 30 September 2013.

Endnote

1. Germany, France, Italy, Spain, Portugal, Greece, Austria, Belgium, Estonia, Slovakia and Slovenia.
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