UK challenges legality of proposed EU Financial Transaction Tax

On 19 April 2013, the UK Chancellor of the Exchequer, George Osborne (the Chancellor), announced that the UK has launched a legal challenge to the European Commission proposal for an EU financial transaction tax (FTT). This Alert covers some key issues and questions arising from the UK’s challenge.

Background to the challenge

The UK Government has consistently opposed a European-only FTT with the breadth and design contained in the EU Commission’s current proposal.

Moreover, concerns about the EU FTT from the City of London, the UK press and UK Parliamentary committees have been increasingly articulated in the last few weeks. A number of recent studies have also highlighted in some detail the potential negative impacts of the EU FTT for the UK and for the City of London.

The UK challenge

The UK is challenging the decision of the Council of the European Union, of 22 January 2013, to establish enhanced cooperation with regard to a European financial transaction tax (2013/52/EU). In the preamble to the decision, it is noted that the 11 participating Member States requested that the scope and objectives of the enhanced cooperation should be based on the European Commission proposal for a Directive of 28 September 2011.

At the time of such decision, the UK indicated that it did not believe the relevant conditions necessary for the establishment of enhanced cooperation were satisfied.
It should be noted therefore, that the UK is, technically, challenging the establishment of enhanced cooperation in the area of the EU FTT rather than the substance of the proposal published by the European Commission on 14 February 2013 - although in practice not much appears to turn on this point.

The UK's challenge should be regarded as protective, as it was lodged just ahead of the deadline for challenging the Council decision authorizing enhanced cooperation. The UK may consider that, if it did not lodge such a claim then there is a risk that it would be precluded from challenging the enhanced cooperation procedure altogether.

The basis of the UK's challenge

The formal application submitted by the UK to the European Court of Justice (ECJ) is not in the public domain at the time of writing.

However, the Chancellor has made clear that the UK's main concern is about the extra-territorial aspects of the Commission's proposal, a concern which other non-participating Member States and third countries such as the US are known to share.

This comment would appear to be aimed in particular at the "deemed establishment" rule contained in the proposal. This rule provides that a financial institution would be subject to the EU FTT simply if it traded with counterparty in an FTT-zone jurisdiction. The UK's concern on this point appears to be exacerbated by the understanding that the Commission is of the view that, in applying the "deemed establishment" rule, it would be necessary to "look through" transactions with, or between, entities that are out of scope of the FTT (such as Central Counter Parties, Central Securities Depositaries and International Central Securities Depositaries). This would mean non-FTT zone counterparties becoming liable to the FTT simply because their trade with an FTT zone exchange is matched by that exchange with an FTT zone counterparty. The EU FTT proposal, in its current form, is potentially vulnerable to a legal challenge by the UK on a number of grounds. The relevant EU Treaty provision (Article 263 of the Treaty on the Functioning of the European Union) cites the following potential grounds for annulment:

- Lack of competence
- Infringement of an essential procedural requirement
- Infringement of the Treaties or of any rule of law relating to their application
- Misuse of powers

The UK may argue that the proposed EU FTT breaches a number of the conditions laid down in the EU Treaties for the use of the enhanced cooperation procedures, and is therefore an infringement of the Treaties and/or a misuse of powers:

- The proposal carries a high risk of financial transaction activity relocating outside the FTT zone or even outside the EU. This would clearly lead to fragmentation of the internal market and distort competition between EU Member States (although arguably the UK will also benefit to a certain extent from relocation).

- Although the EU Commission contends that its proposal is complementary to the wider EU financial market reform program, the UK could contend that in many respects it is contrary to the policy objectives of other measures. So, for instance, the purpose of the European Market Infrastructure Regulation which is to mandate central EU derivative clearing and increase collateral requirements will be frustrated by the EU FTT.

- The proposal has a disproportionate negative impact both on the UK and on City of London, and therefore - crucially - fails to respect the competences and rights of those Member States who do not participate. For example, it has been estimated that the FTT would result in an annual cost to the UK government of £3.95 billion for the issue of non-index linked gilts, and that over 30% of OTC derivatives traded in London would be subject to the FTT. Since the FTT would likely be treated as a normal trading expense incurred by financial market participants for UK corporation tax purposes, it is also possible that the FTT that would be paid by market participants operating in the City of London would be sufficiently large to wipe out their UK corporation tax liabilities. Consequently, the EU FTT would
effectively result in a transfer of fiscal revenues from the UK to the EU11.

Impact of the UK’s challenge on the entire FTT project

At present, it seems unlikely that the UK’s challenge will terminate the entire FTT project.

First, the EU Commission’s reaction is that the FTT proposal is legally sound and in accordance with the EU treaties. France and Germany have indicated that they do not think the challenge will succeed and that they will press ahead with enhanced cooperation.

Second, it may take some years for the ECJ to hear a case on the legality of the EU FTT, by which time the matter will probably be settled politically, one way or another.

Third, the Chancellor has made clear that the UK is not against an EU FTT in principle. It appears that the UK’s challenge is aimed principally at strengthening its negotiating position in discussions with the other Member States – particularly as under the enhanced cooperation procedure, the UK does not (as from the time of the Council decision of 22 January 2013) have any vote on the Commission proposal. The UK’s challenge therefore does not appear to change the fundamental landscape – namely, that the final EU FTT shape and scope will be decided by intensive political discussion and negotiation between the Member States. What however the UK’s challenge will do is to ensure (to the extent that there was ever any doubt) that the EU11 will play close attention to the concerns voiced by the UK and other non-participating Member States.

It is likely that the outcome of the EU FTT project will be determined by “realpolitik” among the Member States rather than the outcome of an ECJ decision.

Finally, even if contrary to expectations, the EU FTT project is derailed, either because of the UK challenge or because the Member States are unable to reach political agreement on what the tax should look like, there is nothing stopping individual Member States from introducing their own unilateral FTTs (as France and Italy have already done). If the FTT was not introduced, it is possible that Spain and Portugal, among others, would resurrect previous proposals for such a tax.

Next steps

Discussions between the Member States since the Commission’s revised EU FTT proposal of 14 February 2013 have not resulted in much substantive progress to date. The next round of FTT meetings between the 27 Member States is scheduled for 22 May. In view of this, a go-live date of 1 January 2014 is very unlikely but that, assuming political compromises are reached, a start date later in 2014 or in 2015 may be achievable.

Next steps for financial institutions

As noted above, the UK challenge does not really change the landscape, although it does serve to reinforce the point that the negotiations between the Member States are likely to be intensive and take some time before political agreement can be reached.

This provides a valuable window of opportunity for financial institutions to engage intensively with key government stakeholders, so that those stakeholders are able to articulate with precision concerns that they have with respect to the FTT and its likely impact – and help
shape the debate about the scope of the tax. It should also allow financial institutions to take time in building systems that accommodate an EU FTT, whatever its precise final shape. Experience with both the French FTT and the Italian FTT demonstrated that manual and short-term operational fixes were possible, if not optimal. However, it is not likely that such an approach would work for the EU FTT applying across multiple asset classes and multiple jurisdictions, and that a strategic solution to the operational challenge is therefore required.

Conclusion

It is not likely that the UK challenge fundamentally alters the overall landscape for FTT. However, there is likely to be a delay to the FTT legislative timetable - and this will provide the financial services community with a valuable opportunity to engage with government and to work up strategic solutions to the operational challenges posed by the FTT.
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