Briefing note 10 September 2013

Is it the end of the line for the FTT?

It is being widely reported that the Legal Service of the Council of the European Union has issued an opinion stating that a key element of the proposed EU financial transaction tax – the "residence principle" – is unlawful.

We look at what this means and ask: how serious are the legal problems the Legal Service has identified? Is this the end of the line for the FTT? Or could the tax survive in a different form?

What is the "residence principle"?

In January 2013, the Council of Ministers authorised France, Germany and nine other EU Member States to proceed with a wide-ranging EU financial transaction tax on securities and derivative transactions. A full proposal was then published by the Commission on 14 February 2013.

The FTT would be applied under the "enhanced cooperation procedure". This enables EU legislation to be enacted by eleven or more member states (forming the "**FTT zone**"), without other states having a right of veto.

The proposed FTT applied in two scenarios.

- First, much like UK stamp duty or the French and Italian FTTs, it applied to transactions in securities issued by a company in the FTT zone. This is the so-called "issuance principle".
- Second, it applied to transactions entered into by a financial institution resident in the FTT zone, even where the subject securities or derivatives had no connection to the FTT zone. This is the "residence principle".

The residence principle was given extra-territorial effect – a financial institution resident outside the FTT zone would be deemed resident in the FTT zone when transacting with an FTT zone party. So, for example, a US bank selling US Treasuries to a German bank would be deemed resident in Germany and subject to the FTT in Germany. This would be the result even if the German bank was acting through its London branch.

Our previous client alerter set out the proposed FTT in more detail.

What was the purpose of the residence principle?

The residence principle had several purposes:

- It greatly increased the tax yield, i.e. because a German financial institution would be subject to the FTT on its worldwide transactions, not just its transactions in FTT zone securities.
- It prevented FTT zone investors from avoiding the tax by choosing to transact in non-FTT zone securities (which would have reduced tax yield further and potentially reduced liquidity and increased the cost of capital for FTT zone issuers).
- It enabled the tax to be applied to all derivatives (as, for example, the issuance principle could not be applied to interest rate or currency derivatives).

What are the legal problems?

We noted in a previous client alerter that there were several legal problems with the proposed FTT:

- The enhanced co-operation procedure can only be used where it doesn't create discrimination in trade between Member States or distort competition between them. It seems reasonably clear that the FTT would distort competition between Member States as a whole. A US bank would, for example, be subject to the FTT when transacting with a German client, but not when transacting with (say) a London client.
- Enhanced co-operation must respect the "competencies, rights and obligations" of those Member States which do not participate in it. But the extra-territorial effect of the FTT means that residents of non-participating Member States will be subject to the FTT. Indeed, they may be taxed twice – a UK pension fund buying UK equities from a French bank would pay the FTT plus UK stamp duty. The FTT may therefore represent an indirect infringement on the non-participating Member States' competencies and rights.
- There are serious grounds for believing the FTT could constitute a restriction on the free movement of capital, and therefore be contrary to EU law. The Commission has conceded that an FTT that applied to forex would be contrary to the free movement of capital – but EU caselaw draws no distinction between forex, securities and derivatives – all are "movements of capital". So, once the forex point is conceded it is not obvious how an FTT that applies to securities and derivatives can be said to be lawful.

The Financial Times have published what purports to be an opinion issued by the EU Council Legal Service agreeing with each of the above arguments (the opinion is confidential but has at the time of writing been widely published). It adds a fourth: that the FTT exceeds Member States' jurisdiction for taxation under the norms of international customary law (and is therefore contrary to the Maastricht Treaty).

Somewhat embarrassingly, the "customary law" and "competencies" arguments are the basis of an ongoing challenge by the UK in the Court of Justice of the European Union against the Council's decision to authorise the use of the enhanced cooperation procedure.

It has been reported that the Commission strongly disagrees with the Council Legal Service's arguments – however we are aware that the Commission themselves held the view as recently as 2011 that aspects of an FTT would be contrary to the free movement of capital.

Does this call into question the French and Italian FTTs?

The French and Italian FTTs are quite different taxes, similar in nature to UK stamp duty. The arguments identified above are therefore largely inapplicable to them.

What happens now?

The Council Legal Service's opinion is in no sense binding. Nevertheless, assuming the leaked document correctly reflects the Legal Service's views, it would be surprising if the eleven Member States were prepared to continue with an FTT based on the residence principle. Even if it survived the UK's current legal challenge, future challenges by taxpayers would be inevitable – and if they succeeded then the cost to the participating member states could be many €bn.

We would therefore expect that in due course the residence principle will be dropped.

This would leave the FTT applying only to debt securities, equities, fund interests and other instruments issued by entities in the FTT zone (with issuance itself exempt, but transfers and redemptions/surrenders taxable).

This would leave a number of important outstanding questions:

- There would be obvious potential for avoidance through synthetic products. Would the scope therefore be expanded to cover derivatives over instruments that are themselves subject to the FTT? The Italian FTT has taken this approach.
- Will stock loans and repos continue to be taxed? This has been one of the most widely criticised elements of the FTT, given the importance of repos as a source of funding for banks.
- Should the FTT continue to apply to sovereign debt? Italy and Spain, amongst others, have been concerned that this would increase the cost of their own debt.

- The same argument can be applied to corporate debt. And given that debt securities are often highly liquid and held for short periods, transaction taxes have a significantly greater effect on debt securities than they do on equities (which is why there are few existing transaction taxes on debt securities). So should the FTT continue to take the novel and untested approach of taxing debt securities?
- Will there be an exemption for intermediaries? If not, the multiple principal-to-principal transactions that are characteristic of modern clearing arrangements will lead to highly distortive "cascade" effects, with as many as ten FTT charges on one sale and purchase of equities. If an intermediary exemption is introduced, would it be as wide as that for UK stamp duty? Or as restrictive as that for the Italian FTT?

If the FTT is recast in this way, most of the FTT's EU law problems fall away. A badly designed tax (for example, one which cascades) could still in our view be subject to a "free movement of capital" challenge. A well designed tax, similar in scope and effect to UK stamp duty or the French or Italian FTTs, would be much more robust.

Given these difficulties and design challenges, perhaps the FTT proposal will be kicked into the long grass. But if the project is to continue, it is to be hoped that more thought is given to fundamental EU law considerations.

Further information

If you would like further details on any aspect of the FTT, or how it applies to your institution or transactions, please speak to your usual Clifford Chance contact or any of those listed overleaf.

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