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Financial Transaction Tax: Update

Recent press coverage has speculated that the European Commission's proposed financial transaction tax (FTT) could be introduced by majority vote, even if the UK and others are opposed.

In this update, we look at whether these reports have any legal basis. We also look at two key difficulties with the current proposal: the “cascade” effect and the fact that, unlike UK and Irish stamp duty, the FTT incentivises banks and others to move their business out of the EU. Finally we attempt to predict what the likely future of the tax will be.

Can the FTT be introduced by a "back door" route that does not require unanimity?

We believe the clear answer is "no". The Treaty on the Functioning of the EU (TFEU) requires unanimity in matters of indirect taxation. Direct tax remains the sole responsibility of Member States, and a new Treaty would be required to extend the EU's competence to direct tax.

There have been several press reports that there are "loopholes" or "back doors" by which an FTT could be introduced without unanimity:

Introducing the FTT as part of VAT. One report stated that VAT is a duty rather than a tax, and so an FTT which was part of the VAT code could be introduced by majority vote. This is incorrect. VAT is an indirect tax under EU law, and Article 113 of the Treaty of Lisbon requires unanimity for all indirect tax legislation.

Introducing the FTT through a loophole in the VAT rules. Another theory is that there is a "loophole" somewhere in the VAT rules through which an FTT could be introduced. We do not believe a loophole of this sort could exist, given that the proposed FTT is a fundamentally different tax to VAT, and VAT law permits only one VAT system to operate in the EU.

Introducing the FTT as a levy on banks as part of a regulatory Directive, which could then be passed by QMV. There is at least some basis for this. For example, when the EU had no power to introduce criminal legislation, the ECJ ruled that criminal penalties could nevertheless be attached to EU environmental legislation on the basis that the penalties were a minor "accessory" required to give effect to the legislation. However extending this argument to the FTT would fly in the face of the explicit unanimity rule in Article 113; furthermore, the FTT would clearly be more than an "accessory". So we again think this theory is wrong.

Abolishing the VAT exemption for financial services. This would also require unanimity under Article 113. Abolition or change to the exemption has been under discussion for some time; however many would regard this change as a potential benefit for the financial sector, as it would allow banks and others to recover VAT on their costs and expenses.

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The cascade effect – and why it creates a dilemma for the European Commission
The "cascade effect" makes the effective rate of the FTT on securities much higher than the headline rate of 0.1% - perhaps ten times higher.

The reason is the chain of trading and clearing that lies behind most securities transactions. A purchase of securities on the London Stock Exchange, for example, ordinarily involves the sale and purchase by a number of parties, including brokers, clearing members and the central counterparty to the clearing system. Each sale will be subject to the FTT (with only the central counterparty exempt), so a typical purchase by a pension fund would look like this:

Vendor →	Broker →	Clearing member →	CCP →	Clearing member →	Broker →	Pension fund
0.1% (if FI)	0.1% 0.1%	0.1% 0.1%	(exempt)	0.1% 0.1%	0.1% 0.1%	0.1%

The FTT therefore "cascades", taking the effective rate for the transaction to 1% (if the original vendor is a financial institution) or 0.9% (if it is not). If the securities pass through market makers as well then the rate will be even higher.

This represents a very significant hidden cost increase for European pension funds and collective investment schemes – who right now generally pay no transfer taxes on bond purchases, and 0.5% on the purchase of UK and Irish equities.

There is no easy solution to this. Stamp duty does not cascade, because it exempts intermediary transactions – but that permits precisely the kind of high frequency trading that the FTT is intended to prevent. This is the Commission's dilemma: to choose between retaining the FTT's current cascade effects (with the consequential high costs for funds and ultimately consumers), or simplifying the FTT so it only applies to the final transfer (and abandoning the policy objective of influencing market behaviour).

Why the FTT incentivises banks to relocate – and why stamp duty does not
Stamp duty on equities, as imposed by Hong Kong, the UK, Ireland and others, applies to purchases of (e.g.) UK shares regardless of where the buyer and seller are located. There is no incentive for the financial sector to move elsewhere.

The proposed FTT, however, applies where a party is located in the EU. So it positively incentivises banks and financial institutions to relocate outside the EU. This is recognised by the Commission, whose impact assessment estimates the derivative market will shrink or relocate by 70-90%.

Indeed for those who relocate (or are already outside the EU) the FTT potentially represents a tax cut. Hedge funds based in the Cayman Islands (for example) are currently subject to UK stamp duty when trading UK equities: in comparison, if stamp duty is replaced by the FTT, then these trades would no longer be taxed when made with other non-EU parties. This strikes us as an irrational result.

There is again no easy solution. Stamp duty can work the way it does because UK equities are most commonly traded on CREST, and SDRT is deducted automatically. Applying this approach to all EU securities traded on all exchanges worldwide would be highly challenging as an administrative matter. But there is no prospect of taking such an approach to derivatives, where there is usually no underlying issuer to whom jurisdiction can be tied.

In its original conception, James Tobin's transaction tax applied worldwide, so questions of jurisdiction and relocation did not arise. These problems are however inherent to any more limited FTT, and the Commission will struggle to solve them.

What happens next?
There are several possibilities.

First, the FTT could in principle be introduced globally: the UK, Ireland and Sweden – currently opposed to the Commission's FTT - have said they would support a global tax. However global agreements are notoriously hard to reach; the G20 failed to reach agreement on imposing any new taxes, and the current US administration, China, Singapore, Canada, Australia and others remain opposed to an FTT. This option therefore seems off the table.

Second, the FTT could be introduced in the EU, perhaps with changes that mollify some of its critics (for example by creating exemptions that prevent cascade effects). However we believe that the UK and other financial centres are unlikely to accept even a modified FTT, given the risk that it could prompt a decline in corporate and personal tax revenues that outweighs the FTT collected (see our previous note here).

Third, the FTT could be introduced under the "enhanced cooperation procedure" in the Eurozone or amongst some other subset of Member States. Enhanced cooperation requires that at least nine Member States participate. The decision to use enhanced cooperation is decided by QMV among the 27, and then unanimity would apply to the Member States participating in the FTT (unless they unanimously decide to switch to QMV). Such a "limited FTT" would still impact on the City of London, as UK banks doing business with Eurozone banks would be subject to the FTT; London branches of Eurozone banks would potentially be subject to the FTT on their worldwide business. But London would still be at a significant competitive advantage compared to Frankfurt and Paris, and we would query if that is something the French and German governments will ultimately be willing to accept. Any limited FTT would also be vulnerable to legal challenge, in particular on the basis that it contravenes the Capital Duties Directive.

Fourth, the FTT proposal could be replaced by a different tax which targets the financial sector but does not have the severe implementation and relocation problems of the FTT. The most likely candidate is the Financial Activities Tax (FAT). This could be charged on a percentage of financial institutions' profits plus a percentage of their employee remuneration above a certain threshold. In other words the FAT is akin to an increase in corporate taxation for the bank sector plus a permanent version of the bank bonus tax introduced by the UK on a one-off basis in 2009.

The FAT has difficulties of its own. It creates competitive distortions between financial services imported to and exported from the EU, and is therefore likely to prompt a degree of relocation. In addition, some Member States (and Germany in particular) may find their constitutions do not permit a tax to apply to one particular sector. But we would not bet against the political impetus behind the FTT turning towards a FAT before the end of 2011.