EU Directive

ENHANCED COOPERATION IN THE AREA OF FINANCIAL TRANSACTION TAX

cep Centrum für Europäische Politik

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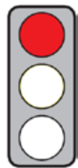
KEY ISSUES

Objective of the Directive: Financial Transaction Tax (FTT) is intended to generate tax revenue and increase the stability of the financial markets.

Affected parties: Parties to financial transactions – including those from non-participating Member States and third countries.



Pro: FTT fulfils its fiscal purpose and generates tax revenue.

Contra: (1) FTT falls short of its purpose of deterring financial institutions from risky activities and avoiding crises. It will not necessarily increase the stability of the financial markets.

(2) The fact that tax liability arises even where only the *other* contracting party, or the security, originates from a participating Member State, stretches the international law principle of territoriality to its limits. Clarification by the ECJ is imperative.

(3) FTT increases the capital costs for companies from participating Member States.

CONTENT

Title

Proposal COM(2013) 71 of 14 February 2013 for a **Directive** of the Council on the **implementation of enhanced cooperation in the area of financial transaction tax.**

Brief Summary

► **Context, objectives and general considerations**

– Following the failure of an EU-wide Financial Transaction Tax [COM(2011) 594, see cep**PolicyBrief**] eleven Member States – Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia – now want to introduce "enhanced cooperation" in relation to the said tax. Thus the Commission has submitted a new, slightly amended proposal.

– Financial Transaction Tax (FTT) includes transactions in "financial instruments". It is intended to (Recital 1)
  - ensure that the financial sector contributes "fairly and substantially" to the costs of the financial crisis,
  - ensure that the financial sector is "taxed in a fair way" vis-à-vis other sectors and
  - generate additional revenue for general budgets or "specific policy purposes".

– It should also (Recital 1)
  - deter the financial sector from "excessively risky activities" and
  - help to avoid future crises.

– The Commission expects annual tax revenue of approx. 31 billion euro. "Part" of this would flow into the EU budget. The GNI-based resource from the participating Member States to the EU would be reduced accordingly. (Explanatory Memorandum page 15)

► **Objects of taxation: Financial transactions in "financial instruments"**

– "Financial instruments" are (Art. 2 (1) No. 3 and 7)
  - transferable securities – i.e. tradable securities such as shares, (government) bonds, securitisations,
  - "money-market instruments" – i.e. securities which are tradable on the money market such as Treasury notes, short-term bonds, deposit certificates,
  - units or shares in "collective investment undertakings" (UCITS) – i.e. investment funds - and in alternative investment funds (AIF),
  - derivatives – i.e. financial contracts whose value is derived from base values such as share prices, commodity prices or exchange rates,
  - structured products ("securitisations") – i.e. debts which have been pooled together as tradable securities.

– The "financial transactions" subject to FTT are (Art. 2 (1) No. 2)
  - the sale and purchase of "financial instruments" before netting or settlement,
  - transfers, between entities of a group, of risks associated with a financial instrument,
  - the conclusion of derivatives contracts before netting or settlement,
  - the exchange of financial instruments,
  - repurchase agreements – i.e. the purchase or sale of securities with the obligation to repurchase or resell them at a later date,
  - securities lending agreements.

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– "Financial transactions" which are exempt from FTT are (Art. 3 (4))
  - first issues (primary market transactions) of transferable securities including government bonds,
  - transactions with the central banks of Member States, the ECB, the European Financial Stability Facility (EFSF), the European Stability Mechanism (ESM) and with the EU related to the provision of financial assistance due to balance of payment problems or severe difficulties such as natural disaster.

► **Tax payers: Financial institutions**

– The Commission wants to ensure that the tax is targeted at the financial sector. FTT is therefore only payable by financial institutions. (Recital 12)
– "Financial institutions" are defined as (Art. 2 (1), No. 8)
  - credit institutions, investment firms, insurance and reinsurance undertakings, pension funds and institutions for occupational retirement provision,
  - regulated markets and any other organised trade venue or platform such as a stock exchange,
  - UCITS and alternative investment funds (AIF),
  - special purpose vehicles created for the implementation of securitisation or for assuming the risks from insurance or reinsurance undertakings and
  - any other undertaking, institution or person carrying out financial activities, where the average annual value of its financial transactions over the last three years constitutes more than fifty per cent of its overall average net annual turnover.
– Liability for FTT arises for a financial institution as soon as (Art. 10 (1))
  - it is party to the transaction, acting either for its own account or for the account of another,
  - it is acting in the name of a party to the transaction, or
  - the transaction has been carried out on its account.

  Where a financial institution acts in the name or for the account of another financial institution, only that other financial institution shall be liable to pay FTT (Art. 10 (2)).
– Liability for FTT does not arise for (Art. 3 (2))
  - Central Counter Parties (CCPs) - i.e. entities for processing transactions between counter parties,
  - Central Securities Depositories – i.e. companies which hold and transfer securities,
  - Member States and public bodies insofar as they are entrusted with the function of managing the public debt.

► **Principle of establishment, issuance principle and determining the country in which tax is payable**

– A financial transaction is subject to FTT where at least one party to the transaction is a financial institution established in the EU (principle of residence) (Art. 3 (1)).
– A financial institution is deemed to be established in a participating Member State if it (Art. 4 (1))
  - has been authorised by a participating Member State,
  - has been authorised by a non-participating Member State and is operating in a participating Member State on the basis of this authorisation (only operations in the participating Member State are taxable),
  - has its registered office or a branch office within a participating Member State,
  - it is party to a financial transaction with another financial institution or with a non-financial institution established in a participating Member State, or
  - it is party to a financial transaction in a "financial instrument" which was issued in a participating Member State (issuance principle); this does not apply to derivatives which are not traded on an organised platform.

  Establishment is determined according to the first condition met in accordance with the descending order of this list (Art. 4 (4)). Tax must be paid to the said participating Member State (Art. 10 (1)).

► **Taxable amount**

The taxable amount,
– in the case of derivatives contracts, is the notional amount; where there is more than one amount, the highest shall be used (Art. 7);
– for all other financial transactions, is the consideration paid; where the consideration is lower than the market price, the latter will be used; for transfers between entities of a group of risks associated with financial instruments, the market price applies. (Art. 6)

► **Rates of tax**

– The Member States determine their rates of tax (Art. 9 (2), sentence 1).
– The EU specifies the following minimum rates of tax (Art. 9 (2), sentence 2 in conjunction with Art. 6 and 7):
  - 0.01% for derivatives contracts, and
  - 0.1% for all other financial transactions.

► **Chargeability, payment and liability**

– FTT becomes chargeable when a financial transaction occurs (Art. 5 (1)).
– In the case of transactions carried out electronically, the tax must be paid at the moment that it becomes chargeable, in all other cases, within three working days (Art. 11 (5)).
– All parties to the transaction (including non-financial institutions) are jointly and severally liable for any tax not paid within the time limit (Art. 10 (3)). Member States may extend the tax liability to persons other than those who are party to the transaction (Art. 10 (4)).

Main changes to the Commission proposal of 2011

A new measure is the introduction of the issuance principle under which all transactions in financial instruments which have been issued in a participating Member State will be subject to FTT. FTT liability for Member States when managing their debts, and for counter parties in relation to transactions with the EFSF and the ESM, has been removed.

Statement on subsidiarity by the Commission

According to the Commission, only a FTT at EU level can prevent the transfer of financial transactions to other jurisdictions and tax arbitrage, avoid distortion of competition and preclude potential double or non-taxation – even if it does not apply to all EU Member States.

Policy Context

In 2011, the Commission proposed a Directive for an FTT for the whole of the EU [COM(2011) 594; see cep**PolicyBrief**] but the required unanimous agreement of the Council could not be achieved. Following this, on 28 September 2012, the Member States now participating requested the Commission to submit a proposal in order to enable an enhanced cooperation in the area of FTT. The Council approved on 22 January 2013 (Decision 2013/52/EU) with the United Kingdom, Luxembourg, Malta and the Czech Republic abstaining. In April 2013, the United Kingdom filed a legal challenge in the European Court of Justice against the Council decision on enhanced cooperation (ECJ, United Kingdom/Council, Case C-209/13).

Legislative Procedure

14 February 2013	Adoption by the Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Leading Directorate General:	DG Taxation and Customs Union
Committees of the European Parliament:	Economic and Monetary Affairs (leading), Rapporteur Anni Podimata (S&D Group, GR)
Leading Federal Ministry:	Ministry of Finance
Leading Committee of the Bundestag:	Finance
Decision mode in the Council:	Unanimity among the participating Member States (abstentions do not constitute dissenting votes)

Formalities

Legal competence:	Art. 113 TFEU (Harmonisation of indirect taxes)
Form of legislative competence:	Shared competence (Art. 4 (1) TFEU)
Legislative procedure:	Special legislative procedure [The European Parliament is only consulted (Art. 289 (2) TFEU).]

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment [see also cep**PolicyBrief** on COM(2011) 594]

During the financial crisis several financial institutions managed to avoid having to assume liability for their own actions. This resulted in these institutions being able to enjoy high levels of state support measures. Therefore, the plan to involve the financial sector in bearing these costs and to prevent such crises in future deserves to be supported.

FTT, however, is not the proper instrument for doing so. It **might**, to a certain degree – depending on the volume of leaked transactions –, create the projected revenues for the public purse and thereby **fulfil its fiscal purpose, but it fails to achieve its steering function, namely to deter financial institutions from enacting risky business transactions, and thus to prevent future crises, and it will not necessarily increase stability in the financial markets. This is because it cannot** systematically **prevent** economically **harmful behaviour** by making it more expensive; **in fact, this will do even greater damage**:

Firstly, there is no conclusive proof as to which financial transactions, employing which financial instruments and under which circumstances, jeopardise financial stability. Only where there is such evidence, can an FTT offer a stabilising incentive.

Secondly, the tax affects all market participants, including those who contribute to efficient price formation thus increasing market efficiency. On the one hand, an FTT can be an appropriate instrument for reducing the attractiveness of high-frequency trading, where traders move in and out of positions in minutes or even seconds, as the tax minimises or even eliminates the often low margins of this trade. However, this should not be overestimated because it does not necessarily lead to a reduction in the volatility of the markets. The tax

would increase transaction costs and thus lead to a reduced number of market participants and to fewer potential business partners. As a result, single transactions could cause more severe price fluctuations. High-frequency trading often contributes to the elimination of market inefficiencies and thus optimises price formation as well (so-called price arbitrage). Moreover, the rising incentives to hold financial instruments for longer also increases the capital costs, as investors will demand payment commensurate to the increased holding periods. This will ultimately reduce the willingness to invest on the part of market players.
Thirdly, the tax could be damaging because it is levied not only upon transactions which allegedly jeopardise the stability of the financial market; derivatives transactions for hedging risks and other economically reasonable transactions would also be taxed and therefore become more expensive.

Impact on Growth and Employment

Higher capital costs resulting from the tax - 0.7 basis points according to the Commission - will reduce willingness to invest, leading to a decline in growth. A negative impact on employment is therefore likely. The Commission expects a 0.53% drop in GDP (Impact Assessment p. 45).

Impact on Europe as a Business Location

The establishment and issuance principles reduce the risk of leakage which is associated with FTT, **but increase capital costs for companies in the participating Member States**. This has a negative impact on these countries as a business location.

Legal Assessment

Legislative Competency

Art. 113 TFEU (Harmonisation of indirect taxes) is the relevant statutory basis for the measure.

Subsidiarity

Harmonisation of FTT would reduce the risk of a leakage of financial transactions and institutions as between the participating Member States. However, this is only of limited relevance if these Member States make use of the leeway available for implementation and fix different tax rates.

Proportionality

Unproblematic.

Compatibility with EU law

States may impose taxes only if there is a sufficiently close link between the item taxed and the sovereign territory of the state concerned ("genuine link"). This results from the international law principle of territoriality, which is also binding on the EU. **The conceivably broad definitions of the establishment principle and the issuance principle, under which tax liability arises where only the *other* party to the transaction, or only the traded security, originates from a participating Member State** – irrespective of whether the transaction takes place in the sovereign territory of the participating state - are problematic in this regard. They **stretch the international law principle of territoriality to its limits. This question requires clarification by the European Court of Justice (ECJ),** which does, in fact, tend towards a broad interpretation of the territoriality principle (cf. ECJ, Case C-366/10 of 21 December 2011).
Restricting the introduction of FTT to the participating Member States restricts the free movement of capital (Art. 63 TFEU). This restriction may be justified, however, if - like the Commission - one takes the view that the Directive also aims to stabilise the financial markets and is thus in the public interest. FTT is compatible with the Directive on indirect taxes on the raising of capital (2008/7/EC). Although the latter does not allow the taxation of securities issues and primary market transactions (ECJ, Case C-415/02 of 15 July 2004), it does permit the taxation of the secondary market.

Compatibility with German law

FTT is only compatible with Art. 3 GG (Equality before the law) if it can be enforced against all taxpayers (BVerfG, 2 BvL 17/02 of 9 March 2004, Tipke Judgement). For this, all transactions subject to tax must be included, in their entirety, including those in third countries. However, it is unlikely that the Federal Constitutional Court will reject FTT: it waives the need to examine whether EU secondary legislation is compatible with basic rights provided there is generally effective protection of basic rights at EU level which essentially corresponds to the protection offered by German law (BVerfG, 2 BvR 197/83 of 22 October 1986, "Solange II" Judgement). It is possible - although not standard practice - for the Federal Constitutional Court simply to refer the matter to the ECJ for a decision. In conjunction with the enforceability of FTT, the question also arises as to whether tax demands can be enforced abroad, particularly in third countries.

Conclusion

FTT fulfils its fiscal purpose but fails to achieve its steering function, namely to deter financial institutions from enacting risky business transactions and thus to prevent future crises and will not necessarily increase stability in the financial markets. The fact that the obligation to pay the tax arises even where only the *other* contracting party or the security originates from a participating Member State, stretches the international law principle of territoriality to its limits. This will have to be clarified by the ECJ. Although both principles reduce the risk of leakage, they increase capital costs for companies in the participating Member States.

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