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Financial Transaction Tax: European Implementation and American Imitation?

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Momentum is building to reform the U.S. tax system and address the nation's fiscal challenges. However, options to raise revenue to reduce the deficit and offset a potential decrease in corporate and individual tax rates are scarce. In this environment, there has been renewed interest in tax policy proposals previously considered unpalatable. One such proposal is a financial transaction tax ("FTT"). The FTT has been catching on internationally, increasing the risk of policy contagion in the U.S.

Emergence in Europe

FTT supporters have proposed the FTT to raise revenue, increase contributions from the financial sector, and reduce certain market behavior such as potentially distortive high-frequency trading. For several decades, the United Kingdom and Sweden have taxed securities trading, though market participants have either evaded these taxes or decided to invest in more tax-friendly countries. More recently, France approved a tax on the transaction of stocks of French-listed companies with a market capitalization of over €1 billion at a rate of 0.2%, and on the transaction of "naked" credit default swaps and certain forms of high-frequency trading at 0.01%. American investors have raised several issues concerning the taxation of specific instruments under this regime, such as the possibility of double taxation of American Depositary Receipts.

Previously, the European Commission ("EC") unsuccessfully proposed imposing a European Union ("EU")-wide FTT. The September 2011 *Proposal for a Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC* would have imposed a tax on the transaction of stocks and bonds at 0.1% and on the transaction of derivatives at 0.01%. The tax would have been imposed on transactions where at least one of the parties was based in the EU and at least one of the parties was a financial institution. The proposed FTT would have raised an estimated €57 billion (\$74.5 billion) annually. However, the EC was unable to secure the necessary member state support to allow for EU-wide adoption of the FTT.

In response, several member states are moving to adopt an FTT through the enhanced cooperation procedure. This alternative approach allows individual EU member states, rather than the entire EU, to adopt the same FTT in each participating country. In addition to backing by the powerful nations of Germany and France, nine other EU states are supportive of member state-level adoption of the FTT: Austria, Belgium, Estonia, Greece, Italy, Portugal, Slovakia, Slovenia, and Spain. The use of the enhanced cooperation procedure is rare; it has only been invoked twice since its creation in the late 1990s under the Treaty of Amsterdam.

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In late 2012, the EC and the European Parliament gave their consent for an FTT to move forward. On January 22, 2013, the Council of the European Union authorized the eleven member states to adopt an FTT through the enhanced cooperation procedure. As a next step, a revised proposal, based on the September 2011 proposal with some amendments, will be released and will have to be adopted by unanimous agreement of the participating member states. An FTT may be in place as early as January 2014. It is expected to generate €10 billion to €35 billion annually.

Many analysts predict that large financial institutions will shift their trading away from countries that adopt an FTT, particularly because the FTT will not be adopted in the United Kingdom or in Switzerland. As a result, small traders, funds, and asset managers without international networks will most likely bear the brunt of an FTT. These costs may ultimately be passed down to consumers, either in the form of reduced yields or charges to retirement and savings accounts, instead of the intended target – financial institutions.

The U.S. and the FTT

Several bills were introduced during the 112th Congress that proposed the establishment of an FTT. Congressman Keith Ellison (D-MN) introduced H.R. 6411, the “Inclusive Prosperity Act.” The bill would have imposed a transaction tax of 0.5% on stocks, 0.1% on bonds, and 0.005% on derivatives or other instruments. Senator Tom Harkin (D-IA) and Congressman Peter DeFazio (D-OR) introduced companion bills, S. 1787 and H.R. 3313, the “Wall Street Trading and Speculators Tax Act.” The bill would have imposed a transaction tax of 0.03% on stocks, bonds, derivatives, and other instruments. Importantly, these pieces of legislation enjoyed the support of other Congressional Democrats, with H.R. 3313 having over 30 cosponsors. Senator Harkin and Congressman DeFazio have announced that they will be reintroducing their bills in the coming weeks.

Of course, the FTT has not been without controversy in the U.S. During the 112th Congress, Congressman Tom Price (R-GA) introduced a bill, H.R. 6616, which would prohibit the Treasury Secretary from assisting any foreign government with the collection of taxes on transactions occurring on U.S. exchanges. The U.S. Chamber of Commerce publicly supported H.R. 6616.

Although initial reaction by U.S. policymakers was lukewarm, an FTT may gain traction in the context of the tax reform and deficit reduction debate. Often overlooked is the fact that the U.S. government already takes a cut on securities transactions in the form of “Section 31 fees.” Exchanges collect these fees from investors and forward them to the U.S. Treasury in order to recover the cost of running the SEC. Section 31 fees generate over a billion dollars in revenue annually. Surplus from Section 31 fees is “subject to appropriation” and available for general federal government spending purposes. Given the current fiscal environment and the dire need for revenue, simply expanding upon this model to collect additional taxes would not be a dramatic leap.

The Joint Committee on Taxation has estimated that the Harkin/DeFazio legislation could raise as much as \$350 billion over ten years. Such an approach may have the benefit of being more politically palatable than additional modifications to tax rates on income, capital gains, and dividends, particularly if there are thresholds put in place to exempt most middle-income retail investors. Moreover, the competitive impact is blunted as the FTT is adopted in EU countries.

U.S. Treasury officials have opposed the FTT because of competitive concerns about the tax’s effect on U.S. capital markets. Instead, they have proposed a financial crisis responsibility fee that would be specifically targeted at certain large financial institutions that received government assistance during the 2008 financial crisis. However, widespread adoption of an FTT in Europe could stem criticism from the U.S. Treasury.

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Conclusion

Given today's fiscal and political climate, adoption of an FTT proposal across the EU and in the U.S. is quite possible. Educating policymakers on both sides of the Atlantic about the dangers such a tax poses to participants in the capital markets is key to containing a possible outbreak.

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