



EU Proposed Financial Transaction Tax – Fortune or Folly?

Since the financial crisis, there has been frequent talk of the introduction of a financial transaction tax. This tax, often referred to as “Tobin tax” after its original advocator, James Tobin, in the 1970s, would impose a levy on individual transactions undertaken by a financial institution. The subject has been discussed at G20 summits since Pittsburgh in 2009,¹ and the European Commission (the “Commission”) has made no secret of its desire to implement the taxation across its 27 Member States.

On Wednesday 28 September in the annual State of the Union address, José Manuel Barroso, President of the Commission, announced the long anticipated proposal for a European financial transaction tax. The tax, if implemented, would impact financial transactions between financial institutions from 2014, charging 0.1% against the exchange of shares and bonds and 0.01% across derivative contracts. The Commission believes the tax, with the potential to raise 57 billion euros per year, would “ensure that the financial sector makes a fair contribution at a time of financial consolidation”² noting, among other things, the significant government bail-outs to support the financial sector during the crisis.

There are significant doubts, however, as to whether the proposal will receive the necessary support to be passed, with business and financial groups in opposition and the UK Treasury unwilling to back such a tax, particularly if it does not have global effect.

Current Financial Taxes

One of the functions of the proposed financial transaction tax identified by the Commission is to harmonise and establish minimum standards for similar taxation provisions that have already been established by a number of European Member States. According to their research, ten countries in the European Union already have a form of taxation on financial transactions running at national level, and the new regulations would complement the existing provisions, providing an element of consistency across the markets, whilst still allowing Member States to build upon the tax with further domestic charges.

¹ Leaders’ Statement, The Pittsburgh Summit, 24-25 September 2009
http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

² European Commission—Press Release, ‘Financial Transaction Tax: Making the financial sector pay its fair share’ (28 September 2011)
<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/1085&format=HTML&aged=0&language=EN&guiLanguage=en>.

The UK, for example, has already implemented taxation in the wake of the financial crisis, responding to public reaction brought about by the substantial bail-outs that UK banks received. In January 2011, the UK introduced a bank levy.³ This taxation is based on the balance sheet positions of each financial institution at the end of the year, rather than imposing tax on every transaction that the institution engages in. The balance sheets are judged, depending on the different amounts of risk-weighted liabilities that the bank owns and the taxation is calculated from that weighting and is therefore designed to impose greater liability in respect of activities considered more risky or speculative. In addition to this bank levy, the UK has had a form of financial transaction tax in place for over 25 years. Stamp Duty Reserve Tax imposes a 0.5% levy on all transactions involving UK shares, bearing more resemblance to the Commission's proposed structure but covering a much more narrow range of transactions.

Overview of the Proposed Financial Transaction Tax⁴

The scope of the proposed financial transaction tax encompasses a broad range of financial instruments, covering those negotiable on the capital markets, money-market instruments (except instruments of payment), units or shares in collective investment undertakings, derivative transactions and the purchase and sale of structured products (including securitisations, warrants and certificates). It would also cover transactions that occur outside an organised market, such as OTC trading in derivatives. This breadth of coverage has been deliberately proposed to prevent avoidance from institutions transacting in complex financial products that can often be close substitutes for each other. The tax would apply to financial transactions where one of the parties to the transaction is established in the territory of a Member State, regardless of whether the trade venue of the transaction is inside or outside the European Union.

The tax would be focused on financial transactions carried out by financial institutions either acting as parties to the transaction for their own account or for the account of other persons, or acting in the names of parties to the transaction. This demonstrates the wide reach of the proposed tax and the desire of the Commission that it is applied comprehensively without the possibility of avoidance measures. The definition of financial institution has been broadly drafted to encompass investment firms, organised markets, credit institutions, insurance and reinsurance undertakings, collective investment undertakings, pension funds, holding companies, financial leasing companies and special purpose entities. Central counterparties and central securities depositories would not, however, fall within the definition of financial institution.

Key exceptions to the scope of the proposal include transactions with the European Central Bank or a national central bank. The Commission also states that activities related to citizens or businesses would remain free from the taxation, such as concluding insurance contracts, mortgage lending, consumer credit and payment services. Currency transactions on spot markets would also be exempt.

The financial transaction tax would be charged by reference to the time that the transaction is entered into (even if the transaction is subsequently cancelled). The tax will generally be levied on the price or value of consideration provided or, in the case of a derivatives contract, on its notional amount. Where the transaction is at an undervalue (for example, between group entities) the taxable amount will be the market price of the transaction at the time it is entered into. It is also envisaged that anti-avoidance provisions will be included. The parties to a taxable transaction will each pay their share of the tax to the Member State where they are established. The tax is to be charged at a rate of 0.1% of the exchange of bonds and shares and at a rate of 0.01% on derivative contracts.

³ Morrison & Foerster LLP News Bulletin, 'UK Proposals for Bank Levies under the June 2010 Emergency Budget' (30 June 2010) http://www.mofo.com/files/Uploads/Images/100630UK_Proposals.pdf.

⁴ European Commission—'Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC' (28 September 2011) [http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/com\(2011\)594_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/com(2011)594_en.pdf).

Reaction to the Proposal

Many business and financial organisations have reacted negatively to the proposal for the financial transaction tax. Criticisms include that the proposals are likely to be detrimental to the financial sector and taxing individual transactions is a less effective method of taxation than the balance sheet bank levy system currently employed in the UK. Although the Commission has estimated that the tax would raise about 57 billion euros a year from its intended implementation date of 2014, many in the financial sector are concerned that additional revenue raised from such a tax will be more than offset by the negative effect it would have on the financial sector and resulting costs to GDP growth. Concerns have also been raised that a tax on individual transactions would give rise to unintended negative consequences to volume and market liquidity hindering the ability of European economies to recover from the effects of the financial crisis. A financial transaction tax of the type proposed by the Commission is likely to result in a significant decrease in the volume of trades, particularly in the high frequency trading markets, as the additional cost of each transaction makes it less profitable to perform. ISDA, the global organisation promoting swap and derivative markets released a press statement⁵ setting out their opposition to a financial transaction tax, arguing that the proposed tax would make it more expensive for institutions to engage in hedging and risk-management transactions, both of which were essential for long-term economic growth and should be encouraged by the financial regulators.

Concerns have also been raised that a system of individual transaction tax may be significantly more difficult to administer than the balance sheet approach with a taxation viewpoint having to be taken in respect of each transaction rather than a singular view at the end of the financial year. This point has been examined further by the IMF, however, who released a paper refuting these administrating problems.⁶

Negative feedback has also been received from groups who believe that the implementation of the financial transaction tax in Europe, without similar provisions in other banking centres around the world, would create a large competitive disadvantage for European centres. City of London officials have expressed concern that up to 80% of income raised from the financial transaction tax could come from transactions based in London. This warning has been echoed by the chief executive of Icap, one of the world's largest inter-dealer brokers, who announced that they would swiftly move their main operations away from Europe if the tax was to be implemented. The UK Treasury has also indicated that it would strongly resist any financial transaction tax that is not implemented globally. Additionally, a House of Lords sub-committee inquiry has been launched to investigate the proposed tax, and is currently requesting comments on the potential impact and effectiveness of the proposal in the UK.⁷ Any responses to the call for comments should be made by 7 November 2011.

The proposal has received some support, however. The French and German governments, having led the calls for transaction taxation in the Commission have stressed its importance; and other nations, including Austria, Belgium, Norway and Spain, are known to support the proposal. The proposal has also received some degree of public support with humanitarian group, Oxfam, pushing for the funds to be used to 'increase justice and provide funding for environmental and social goals'.

The Future

The Commission proposal requires unanimity from the 27 Member States in order to pass. As noted above, the UK government has expressed strong views about the negative impact of the tax and would be expected to use its power of veto to block the implementation of this proposal, unless the tax was to be introduced globally.

⁵ 'ISDA Comments on EC's Proposal for a Financial Transaction Tax' (29 September 2011) <http://www2.isda.org/news/isda-comments-on-ecs-proposal-for-a-financial-transaction-tax>.

⁶ IMF Working Paper, 'Taxing Financial Transactions: An Assessment of Administrative Feasibility' (August 2011) <https://www.imf.org/external/pubs/ft/wp/2011/wp11185.pdf>.

⁷ House of Lords, European Union Committee, "Call for evidence: towards a Financial Transaction Tax" <http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/FinancialTransactionTax/CFEFTT.pdf>.

Similarly, the Swedish Finance Minister has also stated his concerns about how a non-global implementation would drive financial institutions to other areas of the world.

The likelihood of the tax being agreed upon globally by the G20 seems unlikely, with the United States currently adverse to such a transaction tax. Therefore, without global consent, and the UK willing to use its right to veto against the proposal, it seems unlikely that the proposal will be brought into effect across the entire EU.

At the same time, it is clear that the concept of a financial transactions tax has much support within the Commission and significant political support from within the EU. It should therefore be assumed that the efforts to introduce a tax along the lines of the proposal will continue. One option that the Commission has suggested that it would consider if the UK did exercise its right of veto would be to implement the taxation initially in the Euro-zone. Such a proposal would still be likely to have an impact on UK entities entering into transactions with counterparties located in the Eurozone without the UK obtaining any share of tax revenues. Conversely, such a step may result in more business being transferred to the UK exchanges. A successful implementation of the tax, even in a reduced geographical area, might provide support for the tax and persuasion for global implementation at future meetings of the G20.

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