News Bulletin

March 15, 2013

A European Financial Transaction Tax

In September 2011, the European Commission initially proposed that a financial transaction tax ("FTT") be implemented by all 27 EU Member States, although it soon became clear that a significant proportion of the Member States would not agree to implement a tax of the nature proposed.

As a result, a smaller number of Member States, who felt strongly that they wished to proceed with such a tax, wrote to the European Commission in the autumn of 2012, officially requesting a little-known process of "enhanced co-operation" in relation to the FTT. This process involves a group of at least nine EU Member States resolving to progress an initiative proposed by the EU Commission, once it has become clear that unanimous agreement would not be reached across the EU as a whole within a reasonable period of time.

In October 2012, the Commission's proposal to allow such enhanced co-operation on the FTT was backed by the European Parliament and European Finance Ministers, and this has culminated in a final proposal, dated 14 February 2013, for a Council Directive ("Proposed Directive"). When implemented, the Proposed Directive will be binding only in the Member States participating in the enhanced co-operation procedure ("Participating Member States")[1].

Scope of the FTT—Types of Financial Transactions

Article 2.1(2) of the Proposed Directive prescribes the financial transactions to which the FTT will apply as being any of the following:

(a) the purchase and sale of a financial instrument before netting or settlement;

(b) the transfer between group entities of the right to dispose of a financial instrument as owner and any equivalent operation implying the transfer of the risk associated with the financial instrument, where such transfer or equivalent operation does not constitute a purchase or sale;

(c) the conclusion of derivatives contracts before netting or settlement;

(d) an exchange of financial instruments; and

(e) a repurchase agreement, reverse repurchase agreement or a securities lending and borrowing agreement.

[1] Currently, these Member States consist of Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain, although any other Member State is able to join the enhanced co-operation procedure at a later date.

Attorney Advertisement

Exempted from the Proposed Directive are primary market transactions, such as issuing, allotting, underwriting or subscribing for shares or bonds[2], and transactions constituting part of a corporate reorganisation or restructuring. Also exempted are transactions with European central banks, and the EU-level institutions and facilities, such as the European Central Bank, the European Investment Bank, the European Financial Stability Facility and the European Stability Mechanism, as well as transactions with other international organisations or bodies that are recognised as such by the public authorities of the host state.

Financial instruments are defined by reference to Section (C) of Annex I to the Markets in Financial Instruments Directive and include transferable securities, money market instruments, units in collective investment funds (both funds covered by the UCITS (Undertakings for Collective Investment in Transferable Securities) Directive and by the AIFMD (Alternative Investment Fund Managers Directive)) and a very broad range of derivative contracts, such as options, futures, swaps and forwards. Financial instruments, in this context, also include structured products, meaning securitisation bonds (i.e. bonds transferring credit risk) or other tradable securities or financial instruments offered by way of transactions equivalent to securitisations, "involving the transfer of risks other than credit risk", for example the transfer of underwriting risk in insurance securitisations.

The Proposed Directive makes clear that each of the transactions listed in paragraphs (a), (b), (c) and (e) of Article 2.1(2) shall be considered to give rise to only a single financial transaction. This clarification is particularly important in respect of repos, reverse repos and stock lending agreements, given the possibility of them being construed, in accordance with their legal structure, as being two separate transactions (and therefore subject to two instalments of FTT), rather than as one transaction, according to their economic substance. However, an exchange of financial instruments will be regarded as two separate transactions for the purposes of the Proposed Directive, which will potentially have significant consequences in the context of liability management exercises where exchange offers are common.

In addition, a material modification of any of the transactions referred to in paragraphs (a) to (e) of Article 2.1(2) will be considered to give rise to a new transaction for the purpose of the FTT. Examples of material modifications include the substitution of a party, the alteration of the object or scope of the transaction (including its timescale) or where the consideration previously agreed upon for the transaction is altered. In addition, any modification that results in a higher level of FTT is considered a material modification, and therefore a new transaction. This approach is primarily designed to prevent tax avoidance.

To Whom Does the Proposed Directive apply?

The Proposed Directive is intended to apply to all financial transactions where:

- at least one party to the transaction is established in one of the Participating Member States; and
- a financial institution established in one of the Participating Member States is party to the transaction (whether that financial institution is acting for its own account or for another person, or is acting in the name of a party to the transaction).

Financial institutions, in this context, include any of the following:

(a) an investment firm;

(b) a regulated market or other organised trading venue or platform;

[2] In order to preserve fiscal neutrality, the issuance and subscription of shares and units in collective investment funds are not intended to be subject to the FTT. However, secondary market sales and transfers of such instruments, and redemptions of such instruments, are within the scope of the proposed FTT.

(c) a bank or credit institution;

(d) an insurance or reinsurance undertaking;

(e) a UCITS fund, as well as UCITS management companies;

(f) a pension fund, as well as its investment manager;

(g) an AIF fund, as well as its fund manager;

(h) a special purpose securitisation entity;

(i) a special purpose vehicle for insurance purposes; and

(j) any other undertaking, institution or person which carries out one or more of the following activities, in circumstances where the average annual value of its financial transactions constitutes more than 50% of its overall average net annual turnover[3]:

  (i) accepting deposits, lending, financial leasing or issuing guarantees or commitments;

  (ii) trading financial instruments for its own account or on behalf of customers;

  (iii) acquiring holdings in undertakings;

  (iv) participating in or issuing financial instruments; or

  (v) providing services related to the activities in (i) to (iv) above.

Central counterparties and central securities depositories are not considered to be financial institutions for this purpose, where they are not themselves engaged in trading activity.

Territoriality

Article 4.1 of the Proposed Directive provides a list of the circumstances in which a financial institution (though not other parties to financial transactions) is deemed to be established in a Participating Member State. These situations include not only circumstances where the financial institution has its registered seat, permanent address or a branch within that Member State, but also where it has either been authorised by the authorities of that Member State to act as a financial institution or is authorised or otherwise entitled to operate, from outside that Member State, in respect of transactions within that Member State. This provision, therefore, is intended to cover situations where the financial institution operates in a jurisdiction by virtue of a passporting regime, such as that under the MiFID Directive.

A financial institution, which is not established in a Participating Member State by virtue of the above criteria, will however be deemed to be established in a Participating Member State if it is facing a financial institution deemed to be established in that Member State by virtue of the above criteria, or where it is facing a non-financial institution which is established in that Member State.

[3] The average annual value of an entity's financial transactions will be calculated over the three preceding calendar years, with the value of each non-derivative transaction being its taxable amount, and the value of each derivative transaction being 10% of its table amount, each as referred to in "Chargeability of the Financial Transaction Tax" below. In addition, the entity can request that it be considered to be no longer a financial institution, where the average annual value of its financial transactions has not exceeded the 50% threshold in two consecutive calendar years.

A financial institution will also be deemed to be established in a Participating Member State where it is a party to a financial transaction in relation to a financial instrument issued by a person who has its registered seat, or in the case of a natural person his or her permanent address or usual residence, in a Participating Member State, although derivative transactions which are not traded on an organised platform are excluded from the definition of financial instruments for this purpose. The above reflects what is known as the "issuance principle"; according to this principle, where two parties, who are not otherwise established in a Participating Member State, agree a financial transaction in respect of a relevant financial instrument, issued by an issuer organised in a Participating Member State, then each of those two parties to the financial transaction will become subject to the FTT in that Member State.

Article 4.2 provides that a non-financial institution shall be deemed to be established within a Participating Member State if it has its registered seat or in the case of a natural person his or her permanent address or usual residence in that Member State, or if it has a branch in that Member State, it will be deemed to be established there in respect of financial transactions carried out by that branch. Foreign non-financial institutions will also be considered to be established in a Participating Member State where they engage in a financial transaction in a relevant financial instrument which was issued by an issuer located in that Member State, other than derivatives which are not traded on an organised platform.

There is a carve-out to this general issuance principle, which provides that where the person liable to pay the FTT is able to prove that there is no link between the economic substance of the transaction and any Participating Member State, then there will be no deemed establishment of a person in that Member State in respect of that transaction. It is currently unclear as to what type and level of evidence will be required to prove the lack of an economic link, and there is the potential for different Participating Member States to apply different criteria to this provision when implementing the final directive into their national laws.

Chargeability of the Financial Transaction Tax

The FTT becomes chargeable for each financial transaction at the moment it occurs, and is levied on the taxable amount of the transaction.

In relation to non-derivative financial transactions, the taxable amount is everything which constitutes consideration paid or owed from a counterparty or a third party, in return for the transfer. However, where the consideration is lower than the market price, and in respect of transactions between entities within the same group, the taxable amount shall be deemed to be the market price, determined at the moment the financial transaction occurs. "Market price" in this context is defined as the full amount that would have been paid as consideration in an arm's-length transaction.

In relation to derivative financial transactions, the taxable amount of the transaction is the notional amount of the derivatives contract at the time of the financial transaction.

The applicable rates of FTT are to be fixed by each Participating Member State individually, provided that they must be at least 0.1% of the taxable amount for non-derivative financial transactions and at least 0.01% of the taxable amount in respect of derivative financial transactions.

Liability for Payment of the FTT

The Proposed Directive provides that each financial institution, which is party to the relevant transaction, or is acting in the name of a party to the transaction, or on whose account the transaction has been carried out, is primarily liable for payment of the FTT. The FTT is payable to the tax authorities of the Participating Member State in which the financial institution is deemed to be established in accordance with the above criteria. Failure by the financial institution to pay the FTT within the applicable time limit triggers joint and several liability for

Attorney Advertisement

payment of the tax for each party to that transaction. The Proposed Directive also permits Participating Member States to make provisions for persons who are not party to the transaction, to be jointly and severally liable for the FTT.

Each Participating Member State is charged with enacting such obligations as to registration, accounting and reporting as are necessary to ensure effective payment of the FTT, and the European Commission is permitted to adopt delegated acts specifying the measures to be taken by Participating Member States in this respect. Where FTT is payable, it must be paid at the moment the tax becomes chargeable, in the case of transactions executed electronically, or within three working days of it becoming chargeable, in the case of all other transactions.

Anti-abuse Provisions

The Proposed Directive provides for a general anti-abuse rule, which directs Participating Member States to characterise, by reference to their economic substance, "artificial arrangements ... put into place for the essential purpose of avoiding taxation and [which lead to] a tax benefit". In this respect arrangements which lack commercial substance will be deemed artificial, and the Proposed Directive provides various examples of situations which can indicate that arrangements are artificial for this purpose, such as where the legal characterisation of individual steps of the arrangement are inconsistent with the legal substance of the arrangement as a whole, or where the transactions concluded are circular in nature.

In addition to the general anti-abuse rule, the Proposed Directive specifically provides that a depository receipt or similar security, which is issued with the essential purpose of avoiding tax on transactions in the underlying security issued in a Participating Member State, shall be considered issued in that Participating Member State if a tax benefit would otherwise arise. In this respect Participating Member States are directed to consider the extent to which trade in the depository receipt has replaced trade in the underlying security, and where such replacement is deemed to have occurred to a significant degree, the burden of proof will fall on the person liable to pay the FTT to demonstrate that the depository receipt was not in fact issued with the essential purpose of avoiding tax on transactions in the underlying security.

Some Observations

There is a very short timescale for implementing the FTT by way of the enhanced co-operation process. A European Parliament committee vote is scheduled for 28 May 2013, and a European Parliament plenary session is scheduled for 2 July 2013. Once enacted and published, Participating Member States are required to adopt the Proposed Directive by 30 September 2013, and the FTT is intended to apply as from 1 January 2014. It remains to be seen how realistic this proposed timetable is, given the volume of other EU legislations currently in the pipeline.

The issuance principle described above gives the proposed FTT an incredibly broad reach so that it includes circumstances where each of the parties to a financial transaction is established outside the FTT zone, and is not acting from a branch within that zone, but where the subject matter of the transaction consists of financial instruments issued by an entity established within the FTT zone. In these circumstances each of the parties to that financial transaction would separately become liable to pay the full amount of FTT to the authorities of the Participating Member State in which the issuing entity is established.

Unlike the FATCA legislation in the U.S., which is collected by means of a withholding mechanism on U.S.-source payments, the Proposed Directive would (if implemented in this form) allow a Member State in the FTT zone to impose the FTT directly on a foreign person. Quite apart from the issue of whether such an approach breaches any principles of EU legislation, it raises questions as to how the FTT would, in such a case, be levied and collected from the parties to the transaction, by the home Member State of the issuer of the underlying financial instrument. It seems unlikely that other EU Member States outside the FTT zone would feel inclined to cooperate in collecting a foreign tax from its own nationals, in circumstances where that EU Member State did not agree to

Attorney Advertisement

become bound by the terms of the Proposed Directive. It seems even less likely that non-EU jurisdictions would co-operate in this regard.

Another question is how an FTT zone Member State would even become aware of the existence of a financial transaction in the shares of an issuer established in its jurisdiction, particularly if the transaction were effected off-exchange.

Separately, the Proposed Directive is arguably unique amongst post financial crisis legislation, in effectively encouraging the use of derivatives, particularly derivatives transacted over-the-counter, as opposed to on an exchange or other organised platform. This is because, in circumstances where a party wishes to enter into a financial transaction in order to gain exposure, say, to a particular share, and the parties to that financial transaction would thereby become subject to the FTT, then assuming that no leverage is built into the transaction, if that exposure were created not by the sale of the shares themselves, but by entering into a total return swap on those shares, then subject to the final anti-abuse provisions, the FTT payable in respect of that total return swap would be only 10% of the FTT that would be payable on the sale of the shares themselves.

In addition, the exemption of OTC derivatives from the provisions giving rise to the issuance principle means that for two parties to a financial transaction, who have no connection to the FTT zone, payment of the FTT in respect of a transaction linked to an FTT zone-issued share can (subject to the final anti-abuse provisions) be avoided altogether by entering into an OTC derivative on that share, rather than by transacting in the share itself.

However, where a taxable option on a share is sold, then not only will FTT become payable on that sale, but also on the purchase of the underlying shares in order to delta-hedge the option position, or alternatively on the transaction which closes the position. This will make delta-hedging of options on FTT zone equities much more expensive in the future.

It also seems that the extra-territorial scope of the proposed FTT will cause concern for non-FTT zone financial institutions in particular, at least until much greater clarity exists over such matters as what does or does not constitute an economic link to the relevant Participating Member State, and when arrangements surrounding a financial transaction would be considered artificial, for the purpose of the Proposed Directive's anti-abuse provisions. Of particular difficulty is the fact that each of the Participating Member States could in theory have very different laws as to the characterisation of financial arrangements, and the current lack of clarity on such matters from the European Commission makes it extremely difficult for non-FTT zone financial institutions to gauge the extent to which the Proposed Directive will affect their various business lines.

Authors

Jeremy Jennings-Mares
London
+44 20 7920 4072
jjenningsmares@mofo.com

Peter Green
London
+44 20 7920 4013
pgreen@mofo.com

David Goett
New York
+1 212 336 4337
dgoett@mofo.com

Contacts

Thomas Humphreys
New York
+1 212 468 8006
thumphreys@mofo.com

Trevor James
London
+44 20 7920 4087
tjames@mofo.com

Anna Pinedo
New York
+1 212 468 8179
apinedo@mofo.com

Remmelt Reigersman
New York
+1 212 336 4259
rreigersman@mofo.com

Sonia Girgis
London
+1 44 20 7920 4118
sgirgis@mofo.com

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life sciences companies. We've been included on *The American Lawyer*'s A-List for nine straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com. © 2013 Morrison & Foerster LLP. All rights reserved.

For more updates, follow Thinkingcapmarkets, our Twitter feed: www.twitter.com/thinkingcapmkts.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.