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Tax Alert

Luxembourg

EU Financial Transaction Tax in January 2014?

The Commission's revised proposal

In February 2013, the European Commission presented its Proposed Directive implementing an EU Financial Transaction Tax in 11 participating Member States. The FTT will apply, for example, to transactions in equities, bonds, investment funds and derivatives. The tax will have an impact beyond countries that enact FTT and beyond the financial sector.

The European Commission adopted the revised *Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax* (FTT)[1]. The three key objectives are:

- Harmonizing legislation concerning indirect taxation on financial transactions
- Ensuring that financial institutions make a fair and substantial contribution to covering the costs of the recent crisis and creating a level playing field with other sectors from a taxation point of view
- Creating appropriate disincentives for transactions that do not enhance the efficiency of financial markets or of the real economy, thereby complementing regulatory measures to avoid future crises

Under the proposed directive, all financial transactions carried out by "financial institutions" will be subject to FTT where there is an established link to the FTT-zone. In the initial phase, the 11 participating EU FTT-zone Member States will be Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia.

[1] *The enhanced cooperation procedure allows a group of Member States to cooperate within an EU framework without all Member States participating. This allows them to move faster and towards different goals, than those not participating in the enhanced cooperation. The Member States wishing to participate in the enhanced cooperation must address a formal request to the European Commission, describing the scope and the objectives of the cooperation. At least nine of the 27 Member States should sign this request. The enhanced cooperation allows any other Member State to join at later stage upon request.*

Scope

For the purposes of the FTT Directive, financial institutions include, *inter alia*, credit institutions, investment firms, insurance and reinsurance undertakings, UCITS, pension funds, alternative investment funds (AIF), securitization vehicles, regulated markets and other organized trading venues or platforms.

Unregulated entities carrying out certain specified financial activities will be treated as "financial institutions" if the average annual value of their financial transactions is more than 50% of their overall average annual turnover (net of sales rebates and turnover taxes).

Financial transactions include:

- The purchase and sale of a financial instrument before netting or settlement
- The transfer between entities of a group of the right to dispose of a financial instrument as owner and any equivalent operation
- The conclusion of derivatives contracts before netting or settlement
- An exchange of financial instruments
- A repurchase agreement, a reverse repurchase agreement, a securities lending and borrowing agreement

Exchanges of financial instruments should be treated as two taxable transactions. However, repo and reverse repo transactions, and securities lending and borrowing agreements, are to be treated as giving rise to one transaction only.

Each material modification to a taxable financial transaction should be considered as a new taxable transaction.

Exemptions

The following are examples of operations which are not in the scope of the FTT:

- Primary market transactions, including the underwriting and subsequent allocation of financial instruments in the framework of their issue. This implies, for example, that the issue of shares or units in collective investment undertakings will not be in the scope of FTT, but the redemption of such shares or units will be in scope
- Day-to-day financial activities of citizens and businesses, such as lending and credits, payment services, insurance and deposits
- Currency transactions on spot markets
- Traditional investment banking activities in the context of the raising of capital or financial transactions carried out as part of restructuring operations

Exempt entities include: central counterparties, central securities depositories, Member States and public bodies thereof, the European Central Bank, national central banks

What are the key measures of the revised proposal?

- The tax rates must be fixed by each participating Member State, and a participating Member State must apply the same rate to all financial transactions that fall under the same category. Those rates must not be lower than
  - 0.1% for financial transactions other than those related to derivatives contracts
  - 0.01% for financial transactions related to derivatives contracts
- The "residence" principle and the "issuance" principle will apply to determine whether there is a link to the FTT-zone:
  - The "residence principle": the FTT will be due if any party to the transaction is established in a participating EU Member State, regardless of where the transaction takes place. This is the case both if a financial institution engaged in the transaction is, itself, established in the FTT-zone, or if it is acting on behalf of a party established in that jurisdiction
  - The "issuance principle": financial instruments issued in the participating Member States (i.e., issued by a person established in a participating Member State) will be taxed when traded, even if those trading them are not established within the FTT-zone
- Anti-abuse rules: The new proposal contains anti-abuse rules, which would allow participating Member States to treat artificial arrangements aimed at avoiding the tax by reference to their economic substance

Timetable

The draft directive will now be subject to further discussions and negotiations between all EU Member States (including those that are not part of the group of participating Member States), and the European Parliament will be invited to give its (non-binding) opinion on the proposal. The non-participating Member States – such as Luxembourg – can be expected to press for changes to protect the interest of the single market. However, to be adopted, the proposal (with or without further amendments) will need unanimous approval only of the participating Member States. It remains to be seen how soon they will approve a final text.

Once the directive is adopted, the participating Member States will then have to adopt domestic law and administrative provisions to apply the FTT: the current proposal foresees that they should do this by 30 September 2013, at the latest, in order for the FTT to be implemented on 1 January 2014.

This is clearly a very ambitious timetable, as it will require each of the participating Member States to make room for the FTT in addition to their current legislative programmes.

Participating Member States will not be permitted to maintain taxes on financial transactions other than the EU FTT or VAT and, accordingly, the domestic FTT regimes (e.g., France, Italy) would need to be repealed (or at least amended). However, there is no provision proposed to exclude double taxation in cases where a similar tax will nevertheless also apply (e.g., if UK Stamp Duty Reserve Tax is also due); the risk of double taxation in other countries still arises.

Impacts on financial services

The FTT will impact the financial sector in a number of ways, *inter alia*:

- Financial products and investment strategies: the FTT will impact both investors purchasing financial products, and the returns of the products themselves. Financial institutions may need to review the design and investment strategies of their products. Some may no longer be viable
- Availability of savings products to EU citizens: an FTT may lead investors to switch their savings away from products that are in scope (such as UCITS) and towards products that are not covered by the FTT (such as savings deposits and life insurance). As a consequence, an FTT may create an undesirable distortion between providers of long term savings products ultimately reducing the choices available to EU citizens for saving for their future
- Significant cost for financial institutions and their clients: the FTT implies not only an additional tax burden for financial institutions, but also a compliance cost
- Operational burden for financial institutions: given the challenges of making the operational changes to comply with the new FTT, financial institutions need to be working on a strategy and implementation plan as soon as possible. Furthermore, the directive is very light on collection and administration aspects of the tax
- Challenging timeline: this timetable would require financial institutions to make all the requisite operational and IT data changes in a very short timeframe given the likely proposed scope of the tax. Experience with regard to French FTT, and now Italian FTT, suggest that this would be very challenging to meet
- Impact outside the EU: financial services institutions outside of the EU will be liable to pay the FTT in relation to certain transactions
- Weakening the Single Market: a wide-based FTT in a limited number of EU Member States may cause distortions, and provoke a protective reaction that could weaken the Single Market and undermine the safeguards provided by EU regulation of financial markets
- Undermining the operation of capital markets: a broad, residence-based FTT represents a significant risk to the operation of financial markets of participating Member States. As a result of the increased cost and lower volumes of transactions, there will be a reduction in liquidity in securities within those Member States

Impacts on European businesses and citizens

The FTT will impact businesses and citizens as follows:

- Companies will need to implement the systems needed to comply with their FTT obligations. This will involve separating financial transactions by type, location, status of the counterparty, and by place of issuance of the instrument, and having systems to report to, and account to, the tax authorities of the participating Member States
- The cost of FTT will ultimately be borne, in many cases, by businesses and EU citizens, because financial institutions will generally pass on the costs of FTT to the businesses and citizens who are party to the transactions
- Intra-group transactions are in scope as long as one party to the transaction is a financial institution in the FTT-zone
- Corporate treasury, holding companies and potentially operating companies of groups carrying on hedging activities, or involved in dealing and managing risks on their investment portfolios, including through repo and stock lending transactions, will be in the scope of the FTT if the average annual value of their financial transactions is more than 50% of their overall average annual turnover
- Each party to the transaction may be jointly and severally liable for unpaid FTT, including non-financial institutions

Conclusion

The main reason for Luxembourg not to participate to the enhanced cooperation is the risk that such a tax would drive business out of Luxembourg. In our view, an EU FTT creates substantial risks for the EU financial sector and the EU economy. This tax may not generate the revenues estimated by the Commission and the consequences are likely to be undesirable. Impacts on market liquidity, on asset pricing, on market volatility and on the possible relocation of transactions outside the FTT-zone should be carefully considered and evaluated.

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