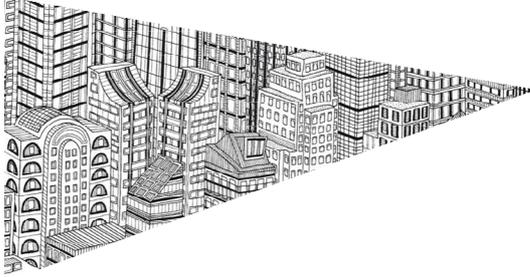


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FTT Alert



# UK challenges legality of proposed EU financial transaction tax

On Friday 19 April 2013, the UK Chancellor of the Exchequer, George Osborne, announced that the UK has launched a legal challenge to the European Commission's proposal for an EU financial transaction tax (FTT).

In this Alert we address some key issues and questions arising from the UK's challenge.

## Background to the challenge

The UK Government has consistently opposed a European-only FTT with the breadth and design of the European Commission's current proposal.

Moreover, the City of London, the UK press and UK Parliamentary committees have increasingly articulated their concerns about the EU FTT in the last few weeks. A number of recent studies have also highlighted in some detail the potential negative impacts of the EU FTT for the UK and for the City of London.

## What precisely is the UK challenging?

The UK is challenging the decision of the Council of the European Union, of 22 January 2013, to establish enhanced cooperation with regard to a European FTT (2013/52/EU). In the preamble to that decision, it is noted that the 11 participating Member States (EU11) requested that the scope and objectives of the enhanced cooperation be based on the European Commission's proposal for a Directive of 28 September 2011.

At the time of such decision, the UK indicated that it did not believe the necessary conditions for the establishment of enhanced cooperation were satisfied.

Therefore the UK is, technically, challenging the establishment of enhanced cooperation in the area of the EU FTT rather than the substance of the proposal published by the European Commission on 14 February 2013 - although in practice not much appears to turn on this point.

The UK's challenge should be regarded as protective, as it was lodged just ahead of the deadline for challenging the Council decision authorizing enhanced cooperation. The UK may consider that, if it did not lodge such a claim, then there is a risk that it would be precluded from challenging the enhanced cooperation procedure at all.

## What is the basis of the UK's challenge?

### The UK's concern

The formal application submitted by the UK to the European Court of Justice (ECJ) is not in the public domain at the time of writing.

However, Mr. Osborne has made clear that the UK's main concern is about the extra-territorial aspects of the European Commission's proposal, a concern that other non-participating Member States, and other countries such as the US, are known to share.

The particular concern seems to be the "deemed establishment" rule contained in the proposal. This rule provides that a financial institution would be subject to the EU FTT simply if it traded with a counterparty in an FTT-zone jurisdiction. The UK's concern on this point appears to be exacerbated by the Commission's view (as we understand it) that, in applying the "deemed establishment" rule, it would be necessary to "look through" transactions with, or between, entities that are out of scope of the EU FTT (such as central counter parties, central securities depositaries and international central securities depositaries). This would mean non-FTT zone counterparties would be liable to the EU FTT simply because their trade with an FTT-zone exchange is matched by that exchange with an FTT-zone counterparty.

### Grounds for challenge

The EU FTT proposal, in its current form, is potentially vulnerable to a legal challenge by the UK on a number of grounds. The relevant EU

Treaty provision (Article 263 of the Treaty on the Functioning of the European Union) cites the following potential grounds for annulment:

- ▶ Lack of competence
- ▶ Infringement of an essential procedural requirement
- ▶ Infringement of the Treaties or of any rule of law relating to their application  
or
- ▶ Misuse of powers

The UK may argue that the proposed EU FTT breaches a number of the conditions laid down in the EU Treaties for the use of the enhanced cooperation procedure, and is therefore an infringement of the Treaties and/or a misuse of powers:

- ▶ The proposal carries a high risk of financial transaction activity relocating outside the FTT zone or even outside the EU. Relocation within the EU would clearly lead to fragmentation of the internal market and distort competition between EU Member States (although arguably the UK could also benefit to a certain extent).
- ▶ Although the European Commission contends that its proposal is complementary to the wider EU financial market reform program, the UK may contend that in many respects it is contrary to the policy objectives of other measures. So, for instance, the purpose of the European Market Infrastructure Regulation, which is to mandate central EU derivative clearing and increase collateral requirements, will be frustrated by the EU FTT.
- ▶ The proposal has a disproportionate negative impact both on the UK and on City of London, and therefore - crucially - fails to respect the competences and rights of Member States who do not participate. For example, it has been estimated that the EU FTT would result in an annual cost to the UK government of £3.95 billion for the issue of non-index linked gilts, and that over 30% of OTC derivatives traded in London would be subject to the EU FTT. Since the EU FTT would likely be treated as a normal trading expense incurred by financial market participants for UK corporation tax purposes,

it is also possible that the EU FTT that would be paid by market participants operating in the City of London would wipe out their UK corporation tax liabilities. Consequently, the EU FTT could effectively result in a transfer of fiscal revenues from the UK to the EU11.

## **Given these points, does that mean the UK's challenge will end the entire EU FTT project?**

At present, this seems unlikely.

First, the European Commission's view remains that the EU FTT proposal is legally sound and in accordance with the EU Treaties. France and Germany have indicated that they do not think the challenge will succeed and that they will press ahead with enhanced cooperation.

Second, it may take some years for the ECJ to hear a case on the legality of the EU FTT, by which time the matter will probably be settled politically, one way or another.

Third, Mr. Osborne has made clear that the UK is not against an EU FTT in principle. We view the UK's challenge as aimed principally at strengthening its negotiating position in discussions with the other Member States - particularly as, under the enhanced cooperation procedure, the UK does not (as from the time of the Council decision of 22 January 2013) have any vote on the European Commission proposal. The UK's challenge seems to be geared, principally, at influencing the shape of the EU FTT rather than looking to derail the project altogether.

Fourth, it is clear that many Member States, including those in the EU11, have in any event voiced concerns about aspects of the EU FTT proposal. For example, the Italian Ambassador to the EU was recently quoted as saying that transactions on government bonds must be excluded from the scope of the EU FTT, and that this is a "red line" for Italy.

Fifth, the EU11 would undoubtedly wish to strengthen the EU FTT regime by encouraging other Member States to join the process, and this may mean further revisions are made to accommodate those countries. Notably, the Dutch Finance Minister recently said that the Netherlands could still sign up to the proposal if its concerns - in particular, an exemption for pension funds - are

met. (The Netherlands has also said though that it is sympathetic to the UK's challenge.)

The UK's challenge therefore does not, in our view, change the fundamental landscape - namely, that the final shape and scope of the EU FTT will be decided by intensive political discussion and negotiation between the Member States. What the UK's challenge will do is to ensure that the EU11 plays close attention to the concerns voiced by the UK and other non-participating Member States.

We therefore believe that the outcome of the EU FTT project will be determined by "realpolitik" amongst the Member States rather than the outcome of an ECJ decision.

Finally, even if (contrary to our expectations), the EU FTT project is derailed, either because of the UK challenge or because the Member States are unable to reach political agreement on what the tax should look like, there is nothing stopping individual Member States from introducing their own FTTs unilaterally (as France and Italy have already done). If the EU FTT was not introduced, it is possible that Spain and Portugal, amongst others, would resurrect previous proposals for such a tax.

## **What next?**

Discussions between the Member States since the European Commission's revised EU FTT proposal of 14 February 2013 have not resulted in much substantive progress so far. The next round of FTT meetings between the 27 Member States is scheduled for 22 May. In view of this, we believe that a go-live date of 1 January 2014 is very unlikely but that, assuming political compromises are reached, a start date later in 2014 or in 2015 is achievable.

## **What steps can financial institutions take in the meantime?**

As noted above, our view is that the UK challenge does not really change the landscape, although it does serve to reinforce the point that the negotiations between the Member States are likely to be intensive and that it will be some time before political agreement can be reached.

There is a valuable window of opportunity for financial institutions to engage intensively with key government stakeholders, so that those stakeholders are able to articulate with precision concerns that financial institutions have with respect to the EU FTT and its likely impact - and help shape the debate about the scope of the tax. It should also allow financial institutions to take time to build systems that accommodate an EU FTT, whatever its precise final shape. Our experience of both the French FTT and the Italian FTT is that manual and short-term operational fixes were possible, if not optimal. However, we do not think that such an approach would work for the EU FTT, as it will apply across multiple asset classes and multiple jurisdictions. A strategic solution to the operational challenge is therefore required.

## Conclusion

We do not think the UK challenge fundamentally alters the landscape for the EU FTT. Our sense is that, in any event, there is likely to be a delay to the EU FTT legislative timetable - and that this will provide the financial services community with a valuable opportunity to engage with government and to work up strategic solutions to the operational challenges posed by the EU FTT.

## More information

Should you have any queries or comments, please reach out to our usual Ernst & Young contact or one of the contacts below:

Rod Roman - Partner  
+44 20 7951 1549  
[rroman@uk.ey.com](mailto:rroman@uk.ey.com)  
London

Geoff Lloyd - Executive Director  
+44 20 7951 8736  
[glloyd@uk.ey.com](mailto:glloyd@uk.ey.com)  
London

Matthieu Dautriat - Partner  
+33 1 55 61 11 90  
[matthieu.dautriat@ey-avocats.com](mailto:matthieu.dautriat@ey-avocats.com)  
Paris

Adolfo Zunzunegui Ruano - Partner  
+34 91 57 27 889  
[adolfo.zunzuneguiruano@es.ey.com](mailto:adolfo.zunzuneguiruano@es.ey.com)  
Madrid

Iain Brown - Partner  
+44 20 795 17546  
[ibrown1@uk.ey.com](mailto:ibrown1@uk.ey.com)  
London

Nacéra Beniken - Senior Manager  
+33 1 55 61 10 69  
[nacera.beniken@ey-avocats.com](mailto:nacera.beniken@ey-avocats.com)  
Paris

Mark Persoff - Partner  
+44 20 7951 9400  
[mpersoff@uk.ey.com](mailto:mpersoff@uk.ey.com)  
London

Marco Ragusa - Partner  
+39 028 814 926  
[marco.ragusa@it.ey.com](mailto:marco.ragusa@it.ey.com)  
Milan

Volker Bock - Partner  
+49 6196 996 27459  
[volker.bock@de.ey.com](mailto:volker.bock@de.ey.com)  
Frankfurt

Nuno Bastos - Partner  
+351 217 912 000  
[nuno.bastos@pt.ey.com](mailto:nuno.bastos@pt.ey.com)  
Lisbon

Thomas Wilhelm - Partner  
+43 1 211 70 1398  
[thomas.wilhelm@at.ey.com](mailto:thomas.wilhelm@at.ey.com)  
Vienna

Fiona Thomson - Director  
+44 20 795 13913  
[fthomson@uk.ey.com](mailto:fthomson@uk.ey.com)  
London

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