

# FTT Newsletter

## A Round-Up of FTT developments across Europe



While there have been no material movements in the details of the EU FTT, there has been increased publicity in the media around the FTT, and lobbying efforts seem to have stepping up recently.

We also bring you a few more details on the legal challenge lodged by the UK against the FTT.

Last, we set out below 10 things we learnt about the proposed financial transaction tax (“FTT”) from the responses provided by the Directorate General for Taxation and Customs Union (“Taxud”), a department of the European Commission (the “Commission”), to questions tabled by EU member states. Those who have followed the FTT process in detail and are familiar with the draft FTT Directive (the “Directive”) will not be surprised by any of the responses, but Taxud’s views affirm a number of concerns about the operation and impact of the FTT in practice if the Directive is introduced as currently drafted.

There have been no material movements in either the French or Italian unilateral FTTs.

### EU FTT



#### Lobbying efforts

The following examples highlight that the FTT is likely, if introduced in its current form, to have materially adverse impacts on financial markets and financial institutions, including outside the FTT zone.

A letter was sent to the finance ministers of the G20 countries. The letter was co-signed by the following bodies:

- Australian Financial Markets Association
- Global Financial Markets Association
- Investment Industry Association of Canada
- Japan Securities Dealers Association
- Korea Financial Investment Association

The letter states that the “unprecedented extraterritorial impacts” of the tax are contrary to G20 principles and also that the FTT would be harmful to economic growth. The wide international authorship of the letter highlights the extraterritorial impact of the FTT, if introduced in its current form. The letter urges the G20 finance ministers to oppose the proposal. It is particularly noteworthy that this lobbying is directed to a broader global audience than just EU institutions. (The EU is itself a member of the G20, as are France, Germany and Italy (which are part of the FTT zone) and the UK (which is not) in their own rights.)

The full letter can be found [here](#).

This follows a report prepared by the IRSG, a City of London/City UK industry body, studying the effect the FTT would have on the bond market. This report computes the impact the FTT would have on investors in bonds and concludes that the bond market would be disproportionately affected by the FTT. The report also notes that the repo market could potentially be severely affected.

Existing stamp, transfer and financial transaction taxes (e.g. French and Italian FTT) do not typically apply to bonds.

The report can be found [here](#).

A number of other reports by specific organisations and industry bodies on the impact of FTT have also recently been made publicly available.

### **Legal challenge lodged by the UK**

On Thursday 18 April 2013, the UK launched a formal legal challenge against the use of the enhanced co-operation procedure ("ECP") to introduce the EU FTT. This date was thought to be the deadline for the filing of such a challenge. The UK Government has stated that it remains hopeful that concerns about the extra-territorial impacts of the EU FTT in its current form can be addressed through the on-going negotiations and discussions.

The Chancellor of the Exchequer said in an interview "We're not against financial transaction taxes in principle ... but we are concerned about the extra-territorial aspects of the (European) Commission's proposal for the tax and I think that concern is shared by some other countries". Countries which are known to have expressed reservations about the EU FTT include Ireland, Luxembourg and Sweden.

The UK Government's challenge is based upon the use of ECP despite the impact of FTT on non-participating Member States in terms of both potential tax cost and collection obligations. Articles 326 and 327 of the Treaty on the Functioning of the EU state "such cooperation shall not undermine the internal markets or economic, social and territorial cohesion ... Any enhanced cooperation shall respect the competences, rights and obligations of those Member States which do not participate in it." There is little precedent in this area, as ECP has only been used on two previous occasions (in the fields of divorce and patent law).

This legal challenge follows the House of Lords' letter to the UK Government which urged legal options to be considered. The House of Lords made the point that the UK authorities could be obliged to collect the FTT under Mutual Assistance Provisions, but, as it was not a participating Member State, may not benefit from the revenues collected.

While at this stage the impact on the introduction of the EU FTT remains unclear, in terms of the timing, the UK's legal challenge casts more doubt on the likelihood of the EU FTT being introduced on 1 January 2014 as the European Commission had originally intended. It may potentially have the effect of encouraging amendments to the FTT directive outside the formal ECP process and ensuring the involvement of non-participating Member States in the design of the FTT.

A spokesman for the European Commission has stated that the Commission is confident that the proposed FTT is "legally sound". A challenge to one of the previous uses of ECP was unsuccessful, although it is thought that the ramifications of the FTT for the functioning of the internal market are markedly different than in that case.

### **Responses provided by the Directorate General for Taxation and Customs Union**

In a "Non-paper" termed "Room Document #3", Taxud provides responses to questions tabled by 7 EU member states on how the FTT would apply in specific examples. Those member states were: the Czech Republic, Denmark, Germany, Finland, Slovenia, the UK and Ireland in its role as Commission President. This "non-paper" is for discussion purposes only and states on its face that it does not have legal status and has been provided for purely illustrative purposes. The next European Council working group for the FTT is scheduled for 22 May 2013.

**1. Overnight repos – on the basis of the FTT as drafted, overnight repos in their current form (outright transfer of title) may become uneconomic and be replaced by pledges instead.** In the example of an overnight repo over EUR 100 million of German bonds, carried out each day over a 250 day business year, the total FTT charge would be 25% of the notional value (i.e. EUR 25 million). It follows that after approximately 4 years the FTT charge would have eroded the entire value of the bonds – most likely sooner, in fact, as the financial institution may have to sell the bonds into the market to raise cash to pay the FTT on overnight repos, and that sale also triggers an FTT charge for the financial institution as seller. As an alternative, pledging the bonds, rather transferring them outright as is currently market standard, would not give rise to any FTT as no sale or transfer takes place (absent a default).

**2. Central counterparties (“CCPs”) - joint and several liability may mean that CCPs such as exchanges and clearers apply FTT to all transactions in practice.** Financial institutions entering into transactions on an exchange or through a CCP or central securities depository seem to be required to know the identity and location of the counterparty on the other side of the exchange in order to be able to ascertain whether they are (by virtue of their counterparty being established in the FTT zone) themselves liable to pay FTT. Where regulations such as the European Market Infrastructure Regulation (“EMIR”) require a transaction to be cleared through a CCP, but the financial institution is not itself a member of that clearing or settlement system, then its transaction with a clearing member entity could give rise to multiple FTT charges on what is economically the same trade (the cascade effect of FTT). The CCP is itself exempt and looked through for FTT purposes. There is no indication in Taxud’s answers of how market participants are expected to be able to identify their counterparty on the other side of an exchange, although it is clear that the CCP is jointly and severally liable for non-payment and Taxud suggests that CCPs may wish to withhold the FTT from all transactions in order to ensure it is collected and paid.

**3. Passporting rights – may not necessarily lead to establishment in the FTT zone.** A financial institution in a non-FTT zone country which is authorised under the Markets in Financial Instruments Directive (“MiFID”) to carry out business in the FTT zone should not be treated as being established in the FTT zone provided that it does not operate in a participating member state. It should be noted that this answer by Taxud is not especially clear and the cross-references seem incorrect, but this may provide some relief for those concerned that every financial institution authorised under MiFID to act throughout the EU would automatically be treated as being established in the FTT zone owing to that regulatory authorisation.

**4. Agency trades – agents are only exempt when on behalf of other financial institutions.** The exemption for agents in Article 10(2) of the Directive only applies where a financial institution is acting as agent for another financial institution, in which case the other financial institution is liable for any FTT. A financial institution acting as agent for a non-financial institution remains subject to FTT. This also illustrates the seemingly arbitrary nature of the FTT, as whether the principal is a financial institution or not impacts the tax authority to which the FTT is paid, that of the agent’s country or that of its principal, even though it is the end buyer of the financial instrument.

**5. Daily margining – may not be subject to FTT.** For reasons which are not entirely clear, Taxud’s answer suggests that daily movements of collateral (e.g. to cover exposure under a stock loan or a derivative) would not be subject to FTT. This will no doubt need to be clarified and tested in more detail, as daily movements of collateral to ensure sufficient margin is posted could result in an enormous charge to FTT.

**6. There will always be a territorial link with the FTT zone where financial instruments are issued in the territory of a participating member state.** If financial institutions or non-financial institutions are able to demonstrate that there is no link between the economic substance of a transaction and the territory of a participating member state then they shall not be deemed to be established in the FTT zone. Taxud does not expect financial institutions to be able to demonstrate the absence of a territorial link with the FTT zone if the transaction involves securities (including derivatives) issued in a participating member state, however. This would mean that this potential exemption from the FTT where there is no territorial link with the FTT zone could only apply if the charge arose owing to one or more of the parties being or being treated as being established in the FTT zone. It is not currently clear what evidence would be sufficient to demonstrate this; the burden of proof in this case would be on the financial institution.

**7. Derivatives – the underlying asset or reference obligation of a derivative does not affect the “establishment” of either party to that derivative.** By way of example, a derivative trading on a platform in the UK which has French shares as its underlying reference asset is not within scope to the FTT when the derivative is bought and sold by two parties neither of which is established in the FTT zone.

**8. Derivatives – FTT is payable by reference to the notional value even if the market value is quite different.** The Directive clearly states that where a derivative has more than one notional value, the higher amount should be used. More positively, FX swaps constitute one single transaction for FTT purposes, rather than one sale and purchase of one currency and one sale and purchase of the other. Where both parties to the swap are financial institutions then it is clear that each will be subject to FTT.

**9. Double taxation may apply.** FTT applies in addition to any other local transaction taxes, such as UK stamp duty reserve tax or Taiwanese transaction tax. This is also the situation under Italian FTT, where certain Italian shares listed in Hong Kong are subject to both Hong Kong stamp duty and Italian FTT.

**10. Payment and collection – participating member states will need to specify registration, accounting, reporting and other FTT obligations.** This may involve mutual assistance by tax authorities in non-participating member states. However, in accordance with the draft FTT Directive, the Commission may implement a framework for “uniform methods of collection”. The Commission is still examining the possibility of “central tax collection” through trading venues or other

market participants. UK stamp duty reserve tax, which is auto-debited by CREST (Euroclear UK and Ireland), the UK's central securities depository or French FTT, which is levied on brokers and custodians, could potentially be used as a precedent in this regard.

In a separate "non-paper", "room document #4", the participating member states have requested clarification from the Commission in relation to certain aspects of the FTT. These requests include what is meant by a sale and purchase of financial instruments, how the tax would be collected (including how it would be collected from non-participating member states), how the joint and several liability principle might work, how the FTT charge on government bond transactions would impact the cost of national debt, the impact on the repo markets and the impact on high frequency trading activities.

We would expect that the participating member states would wish to understand all of these issues fully prior to proceeding with the introduction of an FTT (indeed one may have expected that these questions should have been asked by participating member states prior to voting to go ahead with FTT). This may indicate that there is still some way to go before the participating member states will be ready to introduce FTT, which places further pressure on the 1 January 2014 start date which already appears ambitious.

We will of course keep you updated with developments in this area through our regular FTT newsletters.

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