FTT – where is it now?

Emerging challenges in the impact of taxes on pensions
25 February 2013, Brussels

A bit of history

- On 28 September 2011, the Commission has adopted a proposal for a Council directive on a common system of financial transaction tax (FTT) and amending Directive 2008/7/EC (COM(2011) 594 final);
- The European Parliament adopted a report in favor of the Commission's proposal in May 2012, with only several amendments suggested;
- The European Economic and Social Committee and the Committee of the Regions have both issued positive opinions on the proposal;
- The Council has discussed the proposal under the Polish and Danish Presidencies. During the Ecofin Council meetings in June and July it was ascertained that no agreement is possible in a foreseeable future on the basis of the Commission' proposal. In this context, some Member States (MS) have already indicated that they would like to continue to make progress on the issue, in the context of enhanced cooperation;

A bit of history (2)

- **Between 28 September and 23 October 2012, 11 MS have sent official letters to the Commission, indicating that they are willing to work together, under the enhanced cooperation procedure, for establishing a common form of FTT;**
- **The Commission has analysed the requests of the 11 MS against the conditions laid down in the Treaties:**
  - must be in one of the areas where the Union does not have exclusive competence;
  - shall aim to further the objectives of the Union, protect its interests and reinforce its integration process;
  - such cooperation shall not undermine the internal market or economic, social and territorial cohesion. It shall not constitute a barrier to or discrimination in trade between Member States, nor shall it distort competition between them;
  - any enhanced cooperation shall respect the competences, rights and obligations of those Member States which do not participate in it. Those Member States shall not impede its implementation by the participating Member States;

A bit of history (3)

- when enhanced cooperation is being established, it shall be open to all Member States, subject to compliance with any conditions of participation laid down by the authorising decision;
- the Council and the Commission shall ensure the consistency of activities undertaken in the context of enhanced cooperation and the consistency of such activities with the policies of the Union, and shall cooperate to that end.

The outcome of the analysis was positive; the Commission has decided to adopt on 23 October 2012 a proposal for a Council Decision authorising enhanced cooperation in the area of FTT (COM(2012) 631 final);

The EP has given its consent on 12 December and the Council has authorised the enhand cooperation on 22 January;

On 14 February the Commission has adopted the proposal for a Directive implementing enhanced cooperation in the area of FTT (COM(2013) 74 final), accompanied by additional analysis.

The 11 Member States' requests

- Objectives and scope of the enhanced cooperation in the area of FTT should be based on the original Commission proposal of 2011;
- Evasive actions, distortions and transfers to other jurisdictions should be avoided;
- [Possible economic associated to the introduction of the FTT in a smaller jurisdiction should be carefully analysed]

These issues have been duly taken into account by the Commission when preparing the proposal for the Council decision authorising enhanced cooperation in the area of FTT and the proposal for a Council directive implementing the enhanced cooperation.

Objectives of COM(2013)71 final (similar to the original proposal)

<u>Key objectives</u>

- **To harmonise legislation concerning indirect taxation on financial transactions, which is needed to ensure the proper functioning of the internal market for transactions in financial instruments and to avoid distortion of competition between financial instruments, actors and market places <u>across the enhanced cooperation zone</u>;**
- **To ensure 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;**
- **To create appropriate disincentives for transactions that do not enhance the efficiency of financial markets thereby complementing regulatory measures to avoid future crises.**

<u>Side issue</u>

- **Possible new own resource for the EU budget?**

The 2013 proposal: basic approach

Legal base

- **Article 113 TFEU: proper functioning of the internal market;**
- **11 MS currently have a form of FTT in place (out of these 4 belong to the enhanced cooperation zone (BE, FR, GR and IT), with the perspective of ES and PT to introduce their own national regimes as well.**

Substantive approach

- **Very wide scope in terms of taxable persons (financial institutions), taxable transactions (financial instruments) and markets (both organised trading venues and over the counter);**
- **Ring-fencing of households, SMEs, other businesses, specific financial infrastructures, private and public borrowing, monetary policy etc.;**
- **Mitigating of relocation and avoidance/evasion risks.**

The proposal: scope of the tax

General

- The focus is on financial institutions, which:
  - need to be involved in order to have a taxable transaction
  - are liable to pay and "operator" of tax
- Reference to relevant regulatory EU framework **used as much as possible (definitions of financial instruments and institutions);**
- **Taxing** gross transactions **before netting and settlement.**

Essential framework

- **Covers financial transactions where at least one party to transaction is established in a participating MS and a financial institution "established" in a participating MS is party to the transaction acting either for its own account or for the account of another person or is acting in the name of a party to the transaction**

The proposal: scope of the tax (2)

Financial transactions within the scope of the Directive

- **Purchase and sale of a financial instrument (transferable securities, money-market instruments, units and shares in collective investment undertakings, structured products) before netting and settlement;**
- **Transfers of financial instruments between group entities, which do not qualify as a purchase and sale**
- **Conclusion of derivatives agreements before netting and settlement;**
- **Exchange of financial instruments;**
- **(Reverse) repurchase agreements and securities lending/borrowing agreements.**

A derivatives agreement resulting in a sale or purchase of an underlying financial instrument (physical settlement) triggers an additional taxable transaction.

Specific rules on counting of transactions.

The proposal: scope of the tax (3)

The Directive shall not apply to these financial transactions

- **Primary market transactions (not only in securities, but also in shares/units of UCITS and AIFs);**
- **Primary market transactions now specifically include the activity of underwriting and subsequent allocation of financial instruments);**
- Transactions with central banks of the Member States;
- Transactions with the European Central Bank;
- Transactions with the EFSF and the ESM, transactions with the Euorpean Union in the context of financial assistance or of managemenent of its assets;
- Transactions with the European Union, the European Atomic Energy Community , the European Investment Bank etc. in the context of the EU protocol on the privileges and immunities;
- Transactions with other international organisations or bodies recognised as such by the public authorities of the host State;
- Transactions carried out as part of restructuring operations.

The proposal: scope of the tax (4)

Financial institutions

- **Investment firms;**
- **Organised trading venues;**
- **Credit institutions;**
- **Insurance and re-insurance undertakings;**
- **Collective investment undertakings (including alternative investment funds) and their managers;**
- **Pension funds and managers;**
- **Special purpose entities / vehicles;**
- **Any other undertaking with significant activity in terms of financial transactions** (when the average annual value of its financial transactions constitutes more than 50% of its overall net annual turnover)
- **Exclusions**: Central Counterparties (CCP) , national and international Central Securities Depositories ((I)CSD), Member States and public bodies when acting as managers of public debt.

The proposal: scope of the tax (5)

Territorial application

- **Establishment criteria that indicate also which MS has the right to tax;**
- **A financial institution is deemed to be established in the territory of a participating MS (to be checked in descending order)**: (a) **of authorisation (for transactions covered by that authorisation), (b) where it is authorised or entitled to operate, from abroad (for transactions covered by such authorisation or entitlement), (c) of registered seat, (d) of permanent address or usual residence (e) of branch (in respect of transactions carried out by that branch), (f) of the party to a transaction, in case a non-EU financial institution is party to transaction (or acts in the name of a party) with a financial or non-financial institution established in a participating MS or (g) of the issuer (where the reference company/entity resides) in the case of securities (including structured products), money market funds, units of collective investment funds and derivatives issued by organised platforms;**
- A financial institution is not "established" in a participating MS if it proves there is no link between the economic substance of the transaction and the territory of any participating MS;
- Specific rules for establishment for persons which are not financial institutions.

The proposal: scope of the tax (6)

Not covered by the directive

- **Enterprise borrowing/lending;**
- **Mortgage loans;**
- **Consumer credits;**
- **Insurance contracts;**
- **Deposits;**
- **Spot currency transactions;**
- **Primary market transactions for raising capital through the issuing of shares and bonds;**
- **Real estate transactions;**
- **Spot transactions in commodities (e.g. energy, gold);**
- **Payment transactions, etc.**

Examples (1)

Bank A established in Germany carries out a repurchase agreement with insurance company B established in Spain

- FTT is due once both in Germany and Spain at national rates

Bank C established in France enters into a swap agreement with Bank D established in Switzerland:

- FTT is due twice in France at national rate, by the Swiss bank deemed to be established in France and the FR bank

Bank E established in the BE buys gold from a Russian non-financial institution with significant financial transactions:

- FTT is not due, as the purchase and sale of commodities is not covered by the directive

Bank G established in Switzerland concludes a forward contract on crude oil with an IT oil company (for operations in IT) with significant trade in financial instruments :

- Bank G is deemed established in the IT and FTT is due at IT rate; also the IT oil company is liable to pay the IT FTT

Examples (2)

A German energy utility concludes a forward contract on crude oil with a SI oil company, and only the first one has significant financial trade in financial instruments

- FTT due in DE

Bank H and Broker I who acts in the name of a normal ES industrial company, both established in China, conclude a derivative agreement in China (for operations of the ES company in Spain)

- FTT due at ES rate as Bank H is deemed to be established in ES, the same applies to broker I

Bank J established in AT lends "over-night" EUR 10 mn. to Bank K in SK (possibly backed up by securities as collateral)

- No FTT due as outright lending and borrowing is out of scope of the FTT

Bank L in EE exchanges EUR 2 mn. of shares for bonds with Bank M in DE

- FTT is due at double rate in EE and DE, respectively (two transactions)

The proposal: chargeable event

Moment of chargeability of the FTT

- When the financial transaction occurs (e.g. at moment of purchase/sale or lending/borrowing of a financial instrument or conclusion/modification of a derivatives agreement)
- "Immediate" taxation

Subsequent cancellation

- **Cannot exclude chargeability, except in case of errors**

The proposal: taxable amount

Financial transactions other than those related to derivatives agreements

- **Consideration paid or owed for the transfer**
- **Market price** (at arm's length price) in case :

  - consideration is lower than market price or

  - transfers of financial instruments between entities of a group in case they do not constitute a "purchase or a sale"

Derivatives agreements

- **Notional amount of the derivatives agreement** (underlying notional or face amount that is used to calculate payments made on a given derivatives agreement)

Common provision on exchange rate to be applied

The proposal: rates (1)

Financial instruments other than derivatives and derivatives are different in nature and in terms of market value, so ***rates have to be differentiated between two categories***

Different or single rate for derivatives?

- **Rates could be differentiated according to taxonomy of products and policy goals;**
- **However, as different rates would invite for tax-avoiding design, a single rate is proposed;**
- **A much lower rate than for other financial instruments was proposed so as to cater for the fact that the notional value of the underlying is typically a multiple of the market value/price of replacement for the derivative.**

The proposal: rates (2)

The level of the rates defined in the proposal

- **Allow national top-ups in the participating MS (e.g. for fiscal consolidation or financing of public goods);**
- **Need to be sufficiently high for the harmonisation objective (e.g. The rate of the FR financial transaction tax on shares is 0.2%);**
- **Need to be low enough to avoid excessive market reactions and relocation.**

Tax rates:

0,01% for derivatives and 0,1% for the other transactions (for each party to the transaction)

Character of the rates

- **Minimum rates;**
- **One single rate (for each of the two product groups).**

Leverage in derivatives

Let's assume that the EUR/USD exchange rate is now 1.20 and increases over the week to 1.26. The percentage change is 5%. An option on EUR/USD with a strike price of 1.20 was sold for USD 0.05.

After the exchange rate hike, the same option is priced at USD 0.11. So, a change in value of over 50% occurred. The increase in the EUR/USD exchange rate has a much higher effect on the option = leverage (*effet de levier*).

Taxing a CDS

Let's assume that Investment firm A buys a 5 years credit default swap (CDS) for EUR 100 mn. from Credit institution B in the same Member State (of residence) which has set the tax rate at 0.01%. According to the Directive, each party would have to pay 0.01% x EUR 100 mn. = EUR 10,000 (EUR 20,000 tax revenues from both legs).

If we would compare this with the theoretical alternative of taxing the market price, let's assume that during the lifetime of the contract Investment firm A would have made 10 coupon payments worth in total EUR 5 mn. (0.1% x EUR 100 mn. = EUR 1 mn. per year)

Taxing a CDS (2)

Taxing that with an equivalent rate of 0.2% (using a multiplier of 20) would have also lead to EUR 10,000 revenues for each party in the contract (EUR 20,000 tax revenues from both legs).

One difference would be that applying the rules relating to the determination of the taxable amount laid down in the directive would lead to a full amount paid upfront to the tax authorities as compared to 10 (theoretical alternative) payments spread across a period of 5 years (and a slightly higher present value of the discounted cash flows).

The proposal: payment, verification and specific obligations

- Having in mind that the involvement of a financial institution established in a participating MS is key and that financial institutions execute the bulk of financial transactions, **financial institutions are the persons liable to pay FTT;**
- **Each party to a transaction is jointly and severally liable for the payment in case the financial institution liable has not paid in time; MS might decide that other persons may also be held jointly and severally liable as well;**
- **MS shall lay down registration, accounting, reporting and other obligations;**
- **The Commission may adopt delegated acts to specify these obligations;**
- **The persons liable for the payment of FTT have to submit a return with info on transactions for a given month by 10th of following month;**
- **To avoid unjustifiable cash flow advantages by financial institutions, FTT shall be paid to the tax authorities at the moment the tax becomes chargeable in case of electronic financial transactions and within three working days from chargeability in all other cases;**
- **Uniform methods of collection are envisaged by means of implementing acts (the Commission would be assisted by a Committee);**

The proposal: other provisions

Harmonisation objective

- **<u>Participating</u> MS cannot maintain or introduce FTTs other than the FTT object of the proposal or value-added tax (VAT)**

<u>General anti-abuse clause and a specific one (for despositary receipts)</u>

Interaction with the Capital duty directive

- **<u>Directive 2008/7/EC concerning indirect taxes on the raising of capital cannot be amended as it is already part of the *acquis*</u>**

Proposed implementation

- **As of 01/01/2014 (transposition at the latest by 30/09/2012); after five years, first time by 31/12/ 2016, the Commission will produce a report on the application of FTT under enhanced cooperation, possibly with a modification proposal (review clause)**

Mitigating risks of relocation, substitution and avoidance

Built-in safety features:

- **Wide scope** in terms of financial instruments, institutions and markets;
- Taxation based on **the residence principle** (is able to capture EU financial institutions' trading outside the EU) and on **the issuance principle**;
- Few exemptions or out-of-scope;
- However, **an economic substance rule** was introduced to avoid extraterritorial applications;
- **Low tax rates** (relocation possible to extent the FTT exceeds the extra cost);
- Intra-group financial transactions and exchanges included in the scope;
- **Notional value** of the underlying as the tax base for derivative agreements;
- **Use existing of administrative cooperation tools and data**;
- **General and specific anti-abuse clauses**;
- **Use of existing reporting and data maintenance obligations (MiFID, EMIR) and taxation of both the buyer and the seller, where applicable.**

In the end, a FTT should be implemented in the whole EU27 to achieve better results and address relocation and competitiveness issues

Additional analysis and clarifications

- **ECFIN(2012) – Securities Transaction Taxes: Macroeconomic Implications in a General-Equilibrium Model (economic paper by Rafal Raciborski, Julia Lendvai, Lukas Vogel)**
  - The impact on GDP for instance (0.28% of GDP – deviation from the baseline scenario) on the long term (40 years) was found to be weaker than in the initial Commission Impact Assessment accompanying the proposal (0.53% of GDP taking into account the mitigating effects in the actual legislative proposal) when using more realistic assumptions in terms of types of financing used in the economy.
- **Seven notes containing additional analysis were published in May 2012 on DG TAXUD's webpage dedicated to FTT, including one dedicated to pension funds**

Expected economic impacts (1)

Revenue effects

- FTT has the potential of raising **significant tax revenue** (EUR 30-35 bn.);
- **Geographical spread of revenue depending on the establishment criteria** of the financial institutions involved in financial transactions (Art. 4).

Macroeconomic effects:

- **No negative impact on GDP expected in the long run**, especially when tax revenues generated would be used to reduce other distorting taxes or to stimulate growth-enhancing public and private investment;
- **No negative impact on employment**;
- **Possible impact on market behaviour and business models** (automated trading affected through transaction costs increase);
- **No impact on the effectiveness of monetary policy <u>and debt management</u>**;
- **Non-financial economy largely ring-fenced**;
- In any event, **the impact assessment is by definition subject to the specific limits of economic modelling**.

Expected economic impacts (2)

Market reaction/functioning

- **The turnover on securities markets is assumed to decline by 15 to 20%**, namely with respect to the segment of HFT (up-front market shrinking);
- **The turnover on derivatives markets is expected to decline by 70 to 90%** in some market segments, especially in the market segment of HFT and highly-leveraged products (up-front market shrinking);
- **The withdrawal of significant parts of the** (virtual) **liquidity provided by HFT and highly-leveraged derivative products should contribute to a better functioning of financial markets**, namely by re-establishing the link with the non-financial economy and consolidating inflated turnover figures.

Impact on financial centres

- **Important decline in the** (inflated) **turnover in some market segments** (namely HFT and highly-leveraged products);
- **Need for some business models** to adjust to the new tax environment;
- **No impact on employment.**

New additional analysis/impact assessment

Basic questions

- **Should certain products (repurchase agreements, secondary market trading in government bonds or derivatives) be exempt?**
- **Should certain actors (regional and multilateral development banks, market makers or pension funds) be exempt?**
- **Should certain products or actors be temporarily exempt (step-by-step approach)?**

Impact of possible exemptions

- **Respect the authorising decision and the requests from the 11;**
- **Significant impact on revenues;**
- **Need to ensure a level-playing field/tax neutrality.**

New additional analysis/impact assessment (2)

Strengthening measures against relocation and avoidance

- **The addition of elements of the residence principle which would also secure additional revenues of around EUR 1.1 bn.;**
- **Re-establishing the power of the authorisation criterion.**

Revised revenue estimates

- **Revenues between EUR 30 and 35 bn.;**
- **Use of proxies (the size of the banking sector as measured by the net operating income) —› EU11 = 59.8% EU27;**
- **Extention of the primary market exemption to units/shares of UCITS and AIFs;**
- **No revenues included for repos as a change in the business model and/or contract design was expected.**

Limited impact on pension funds

Factors limiting the impact of FTT

- **Primary market transactions are exempt (<u>including the activity of underwriting and subsequent allocation of financial instruments</u>);**
- **<u>Primary market exemption for units/shares of UCITS and AIFs</u>;**
- **<u>Revised counting rule for (reverse) repos</u>;**
- **Certain assets remain tax-free: cash/currencies, deposits, loans, real estate, gold and silver etc.**

Similar actors/products are kept in the scope of the proposal

- **Insurance undertakings/products;**
- **UCITS/units of collective investment funds;**
- **Various types of bonds etc.**

Thank you for your attention!

Any questions?

More information can be found at:

http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.htm

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