

EU financial transaction tax: Legality and challenge

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Chris Hutley-Hurst and Jonathon Egerton-Peters, of Skadden, Arps, Slate, Meagher & Flom (UK), discuss the legality of the EU financial transaction tax (FTT) and explain how taxpayers or member states may seek to challenge it.

On February 14 2013, the European Commission published its latest proposal for the EU financial transaction tax.

As the original FTT proposals were unacceptable to a number of member states, including the UK, the intention is to use the enhanced cooperation procedure (ECP) to implement the FTT from January 1 2014 in 11 member states (FTT zone).

This article examines the FTT's legality and the possible methods of challenging its implementation.

Application of FTT

The FTT applies to a wide range of over-the-counter (OTC) and on-exchange transactions – including sales, purchases, repos and exchanges – involving an extensive range of instruments – including securities, derivatives and fund units – though primary market transactions, such as loans, spot FX transactions and certain corporate restructurings are not within its scope.

There are limited exemptions and, most notably, there is no market maker or intermediary exemption. The FTT applies to transactions before netting or settlement, so intraday trading will not avoid it.

It has a very wide, extra-territorial scope. A financial institution – which includes banks, brokers, funds and holding companies – is charged FTT where it:

- Enters into a financial transaction as agent or principal; and is either:
 - within the FTT zone by virtue of regulatory authorisation, incorporation, branch, permanent address or usual residence (where incorporated in the FTT zone, all branch transactions throughout the world will be subject to FTT);
 - transacting with any person (whether or not that person is a financial institution) who is:
 - within the FTT zone by virtue of regulatory authorisation, incorporation, branch, permanent address or usual residence; or
 - not within the FTT zone but the subject matter is a financial instrument that is issued by a person within the FTT zone.

A financial institution can be excluded from charge if it can show that there is no link between the economic substance of a transaction and the FTT zone. This exclusion is expected to have limited, if any, scope.

Each financial institution will be liable for its own FTT charge, and jointly and severally liable for the FTT charge of any other party to the transaction. Other persons can also be jointly and severally liable as well.

If the financial institution is acting as agent for another financial institution, it can be exempted from its own FTT charge, though it will remain jointly and severally liable for the FTT charges of other parties to the transaction.

Rates will be at least 0.1%, with 0.01% for derivatives. However FTT zone member states have the freedom to set their own rates at higher levels, and critically, FTT ignores the tenor of any transaction, so a series of overnight repos can trigger increasing FTT costs.

Double tax charges can arise where there are non-FTT zone transfer taxes triggered. There may also be scope for double FTT charges for tri-partite transactions where a financial institution outside the FTT zone transacts with two other parties within different FTT zone member states.

There is a wide general anti-abuse rule and a targeted anti-abuse rule for depositary receipts. The scope of these anti-abuse rules is wide (for example, no actual intent to avoid the tax is needed) and they create uncertainty in many situations.

Example

UK Investment Manager (UKIM) of a Cayman Fund (not shown) enters into a derivative with Broker, who hedges its exposure by buying UK Shares from US Bank.



- If UKIM and Broker are UK companies (Broker being UK Broker), no FTT charges apply and UK Broker has the usual 0.5% UK stamp duty reserve tax (SDRT) charge on the purchase of UK shares.
- If Broker is a UK branch of a German Bank (FTT Broker):
 - In relation to the purchase of UK shares:
 - FTT Broker has a German FTT charge and a UK SDRT charge; and
 - US Seller has a German FTT charge.
 - In relation to the derivative:
 - FTT Broker has a German FTT charge;
 - UKIM has no German FTT charge on the basis that it is the agent of Cayman Fund;
 - Cayman Fund is likely to have a German FTT charge as it is "party to" the derivative, though there are arguments against this based on the civil law view of agency.
- If UKIM "gives up" the derivative to another party, this could be a "material modification" that creates another transaction that causes FTT charges.

Legality

The example above demonstrates how the FTT may create strong disincentives for financial institutions based outside the FTT zone to trade with FTT zone counterparties. In choosing between UK Broker and FTT Broker:

- UKIM is more likely to choose UK Broker over FTT Broker, assuming their prices are the same;
- FTT Broker must have a lower price than UK Broker to remain competitive; and
- UK Broker can more readily undercut FTT Broker because it does not have to factor FTT into its price.

This is a highly simplified example. In practice, the sale of UK Shares to Broker may well involve a number of transactions, each of which could be subject to the FTT given that exemptions for market makers and intermediaries are absent from the current proposal. Therefore, while the minimum FTT rates may at first appear low, FTT charges can multiply. Similarly, in high volume, low margin transactions, even one FTT charge can negate or compromise the margin.

This competitive asymmetry seems to fly in the face of key components of the FTT's pertinent legal basis, namely Article 113 of The Treaty on the Functioning of the European Union (TFEU). This article provides for the adoption of indirect taxation provisions to the extent that they are, among other things, necessary to avoid distortion of competition.

Similarly, Article 326 TFEU requires that use of the ECP shall not distort competition between member states. In our view, a proposal which fails to reduce the risk of distortions in the market, and which instead appears to create even greater distortions of competition, creates grounds for legal challenges under the TFEU.

The FTT's stated aim of harmonising legalisation concerning indirect taxation is also subject to criticism.

As noted, the FTT rates proposed are merely baselines. Each FTT zone member state is therefore free to choose rates above those, as well as having discretion over rules regarding liability of others, collection and reporting.

The suggestion therefore that the FTT will create or ensure that there is a common system of tax applicable to particular financial transactions is not accurate. In turn, this raises questions whether use of the ECP fails to reinforce the integration process of the Union, undermines the internal market and any sense of economic cohesion across the EU, the result of which would be to breach relevant ECP treaty provisions.

There are further arguments that the FTT may breach core freedoms secured under EU law, including the free movement of capital. Indeed, the European Commission accepted in the Explanatory Memorandum to the FTT proposal that applying the tax to spot FX transactions would breach the free movement of capital. This said, there appears to be no consideration why other movements of capital which would be subject to FTT would not also be restricted in a way that contravened EU law.

Challenge

In its press release which accompanied the current proposal, the European Commission said that the FTT is expected to deliver revenues of €30-35 billion (\$38.8-45.3 billion) per year.

The cost of implementation and compliance for financial institutions caught by the proposal is also likely to be considerable. Given the huge amounts at stake, and with the FTT's legal foundations subject to criticism on a number of levels, challenges to the FTT seem highly likely, if not inevitable.

Action for annulment

One procedure which might form the basis for any challenge is the action for annulment under Article 263 TFEU. This direct form of action permits the Court of Justice of the European Union (CJEU) to review the legality of legislative acts and other acts of the EU institutions which are intended to produce legal effects impacting third parties. The review can be carried out on a number of grounds, including a lack of competence to introduce a particular measure and the infringement of treaty provisions, both of which may be relevant to the FTT.

Though the Article 263 remedy could, if successful, result in an FTT Directive being declared void, it presents a number of hurdles. In particular, it has historically been difficult for private parties to establish that a particular EU measure is of sufficient direct and individual concern to them, to entitle them to bring a challenge under Article 263. By contrast, privileged applicants, which include member states, face no such hurdles; they are presumed to have sufficient interest in the legality of all Community acts and have automatic standing to apply for annulment of a measure under Article 263. This point is worth bearing in mind for several reasons.

First, the possibility that a member state might seek to challenge the FTT under Article 263 is not merely hypothetical. In January this year, for example, Luxembourg declared that it opposed the use of ECP as a tool to impose a tax on which agreement could not be reached across all member states, while reserving all of its legal remedies available in case it considered that the tax did not respect relevant treaty provisions on ECP or was incompatible with the good functioning of the internal market.

More recently, the UK's European Scrutiny Committee suggested in its 34th report, published earlier this month, that when the draft Directive is debated by the European Committee, its members will still want to consider whether it is in the UK's interest to challenge the FTT before the CJEU.

Secondly, faced with the hurdles of bringing an Article 263 claim for themselves, private parties should carefully consider whatever abilities they may have to lobby governments which could take forward a claim as an effective way of ensuring the FTT is scrutinised under Article 263.

Preliminary reference

The above said, it is not the case that private parties might not have an active role in a challenge to the FTT. The long-standing procedure for member states' national courts to make a preliminary reference to the CJEU under Article 267 TFEU is a further way in which the FTT's validity might be subject to review and one which could be used by private parties.

The preliminary reference procedure permits, and in some instances requires, national courts to refer questions on the interpretation of the treaties and the validity and interpretation of EU acts to the CJEU.

Those questions are addressed by the CJEU in order for the national courts to apply the results to the particular dispute before them. The procedure has been used previously in relation to a number of tax measures and can result in the CJEU declaring particular measures of EU law invalid. It is only the CJEU which can declare an EU measure invalid, hence the importance of the preliminary reference procedure in the context of an FTT challenge.

Opportunities for a preliminary reference might arise in the context of numerous disputes in member states' courts.

Though the UK has no plans to implement FTT, a variety of disputes may be presented to the English courts which act as a springboard for preliminary references to be made. Some of those disputes may also present suitable opportunities for financial institutions to join claims or engage in group litigation.

Though the average time for completion of the preliminary reference procedure is just over 16 months, this can be accelerated to 10 weeks in exceptional circumstances.

As there may also be scope to bring such references after a final form FTT Directive is published, but before it is due to be implemented, in the right circumstances the CJEU could be called upon to review the legality of the FTT in advance of its implementation by the FTT zone member states.

Much work is needed to refine the FTT proposals to limit their scope. It remains to be seen whether the tax will be challenged, and by whom (whether member states or private person(s) acting singularly or as a group), though we believe challenges are likely given the FTT's questionable legality.



The Court of Justice of the European Union may be asked to consider the FTT's legality in the near future

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