FINANCIAL TRANSACTION TAX

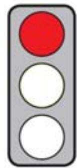
Status: 12 December 2011

Centrum für Europäische Politik

MAIN ISSUES

Objective of the Directive: The Commission is planning to introduce an EU-wide financial transaction tax (FTT) in order to create new revenues for the public purse and to increase the stability of the financial markets.

Parties affected: Parties to a financial transaction (financial and non-financial institutions), tax authorities.



Pros: -

Cons: (1) The FTT cannot deter financial institutions from entering into risky transactions and therefore does not guard against future banking crises.

(2) Fixing minimum tax rates creates leakage risks within the EU. This can jeopardise financial market stability.

(3) It is questionable whether taxing financial institutions seated in third countries is even admissible at all.

CONTENT

Title

Proposal COM(2011) 594 of 28 September 2011 for a **Directive** of the Council on a common system of financial transaction and amending Directive 2008/7/EC.

Brief Summary

► **General and Objectives**

– The main objective is the introduction of an EU-wide financial transaction tax (FTT) in order to tax financial instruments. It serves to (Recital 1):
  - ensure that the financial sector contributes to the costs of the financial crisis;
  - ensure that the financial sector is "taxed in a fair way" compared to other sectors; and
  - generate revenue for the public purse.

  In addition, it is to (Recital 1):
  - motivate the financial sector to take part in less risky transactions; and
  - prevent future crises.

– The tax is to apply to a "wide range of financial instruments", both in the organised markets and "over-the-counter", and to a "broadly determined range of financial institutions" (Recital 3).

– The Commission expects EU-wide tax revenues of roughly 57 billion Euros a year. They are to flow "wholly or partly" into the EU budget through an own resources system of the European Union [COM (2011) 510; s. CEP Policy Brief]. (Recital p. 12, 13).

► **Tax object: financial transactions with "financial instruments"**

– "Financial instruments" are (Art. 2 (1), (2) and (6)):
  - transferable securities (i.e. tradable securities such as shares, (state) bonds, securitisations);
  - "money-market instruments" (i.e. securities tradable on the money-market, such as treasury bills, short-term debt securities, certificates of deposit);
  - shares in "collective investment undertakings" (UCITS; i.e. investment funds) and in alternative investment funds (AIF);
  - derivatives (i.e. financial agreements whose value derives from basic values such as share price developments, commodity prices or exchange rates);
  - structured products, ("securitisations", i.e. claims which are bundled and converted into tradable securities).

– "Financial transactions" subject to FTT are (Art. 2 (1) No. 1):
  - the purchase and sale of "financial instruments" before netting and settlement of mutual liabilities;
  - repurchase (i.e. acquisitions and sales of securities with the obligation to sell or repurchase them later) and securities lending and borrowing agreements;
  - transfers of risks associated with the "financial instrument" within a group;
  - the conclusion or modification of derivatives agreements:

– The first issue ("primary market") of transferable securities (incl. state bonds) is not subject to FTT. This exception does not apply to primary market transactions with shares in UCITS and in alternative investment funds (AIF) (i.e. funds which mainly acquire means from professional investors in order to invest them e.g. hedge, resource or real property funds). (Art. 1 (4))

► **Tax subject: Financial institutions**

– The Commission wishes to achieve the specific taxation of the financial sector. Consequently, only financial institutions are to pay FTT. (Recital 12)

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- "Financial institutions" are (Art. 2 (1) No. 7):
  - credit institutions, investment firms, insurance and reinsurance undertakings, pension funds or institutions for occupational retirement provisions;
  - regulated markets and other organised trading platforms such as stock exchanges;
  - UCITS and alternative investment funds (AIF);
  - (securitisation) special purpose entities or insurance and reinsurance undertakings; and
  - other undertakings which carry out a "significant" volume of financial activities (e.g. taking deposits, acquire shareholdings or trade with financial instruments).
- A financial institution is subject to FTT once (Art. 9 (1) and (2)):
  - it is party to the transaction, acting either for its own account or for the account of another person;
  - it is acting on behalf of a party to the transaction; or
  - another (non-) financial institution has a party acting on its account.

  If a financial institution acts on behalf of or on the account of another financial institution, only the latter is subject to taxation (Art. 9 (2)).
- The Directive does not apply to (Art.1 (3))
  - the European Financial Stability Facility (EFSF) and the future European Stability Mechanism (ESM);
  - central counterparties (i.e. institutions for carrying out transactions between counterparties);
  - central securities depositories (i.e. undertakings for the deposit and transfer of securities).

► **Territory of taxation (residence principle)**

- The taxation of financial transactions is carried out on the basis of the residence principle (Recital 13).
- A financial transaction is subject to FTT if at least one of the transaction parties is a financial institution established in the EU. In so doing, this institution may also act for the account of another person or on behalf of a party to the transaction. (Art.1 (2))
- A financial institution is deemed "to be established in the EU" if it (Art. 3 (1))
  - was authorised by a Member State of the EU;
  - has its registered or usual residence or a subsidiary within a Member State; or
  - is party to the transaction with another financial institution established in that Member State or with a party established in the territory of that Member State and which is not a financial institution (inclusion of non-EU financial institutions).

  Residence is determined by the first condition that is met in descending order (Art. 3 (2)).

► **Taxation basis**

The taxation basis is as follows:

- For derivative transactions: the notional amount (the underlying variable that is used to calculate payments) of the agreement; where more than one notional amount is identified, the highest amount is to apply (Art. 6);
- with all other financial transactions the consideration paid or owed applies; if the consideration is lower than the market price, the latter applies. In the case of a transfer of risks associated with financial instruments within a group, the market price applies. (Art. 5).

► **Tax rates**

- The Member States fix their own tax rates (Art.8 (2)). They should be "sufficiently high for the harmonisation objective" to be achieved but at the same time "low enough so keep delocalization risks to a minimum" (Recital 14).
- In so doing, the following minimum rates apply (Art. 8 (2) in conjunction with Art. 5 and 6):
  - 0.01% for derivative transactions and
  - 0.1% for all other financial transactions.

► **Chargeability, tax payment and liability**

- Chargeability is accrued on carrying out a financial transaction (Art. 4 (1)). It remains in existence even if it is subsequently cancelled or rectified. Cases of error are exempted from this rule. (Art. 4 (2))
- In the case of transactions executed electronically, the tax is to be paid at the point when chargeability is accrued, and in all other cases three working days later (Art. 10 (4)).
- All transaction parties (also non-financial institutions) are jointly and severally liable for any defaults on payment of the taxes due (Art. 9 (3)). Member States are entitled to extend liability to include parties not involved in the transaction (Art. 9 (4)).

► **Implementation by Member States**

Member States must apply the provisions of the Directive from 1 January 2014 (Art. 17 (1)).

Changes to the Status quo

To date, there are no EU provisions on the financial transaction tax.

Statement of Subsidiarity by the Commission

According to the Commission, only a uniform definition at EU level of the "essential features of a financial transaction tax" can help avoid the undue leakage of transactions and market participants and substitution of financial instruments within the EU and prevent "potential double or non taxation". Thus market distortion is avoided and the "proper functioning of the internal market" is ensured.

Policy Context

In March 2010, the European Parliament adopted a resolution on taxation in the financial sector. In October 2010, the Commission compared within a Communication [COM(2010) 549] the FTT with a financial activities tax which taxes the profits and remunerations of financial institutions. The result was that in the case of a unilateral introduction of a financial tax at EU level, the financial activities tax would be "more promising", as a financial transaction tax entails a high risk of leakage. Nonetheless, on 29 June 2011, the FTT was included in the "Proposal on the system of own resources of the European Union" [COM (2011) 510, s. CEP Policy Brief] as a new potential part of EU own resources. In its final statement of 4 November 2011 in Cannes, the G20 did not call for the introduction of an FTT; it simply took note of the fact that several of its members wished to introduce it.

Legislative Procedure

28 October 2011	Adoption by the Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union

Options for Influencing the Political Process

Leading Directorate General:	DG Taxation and Customs Union
Committees of the European Parliament:	Economic and financial affairs (in charge), rapporteur: Anni Podimata (S&D Group, GR); Budget; Development, Internal Market and Consumer protection; Legal Affairs
Committees of the German Bundestag:	Finance (in charge); Economic Cooperation and Development; Affairs of the European Union; Economics and Technology; Budget
Decision mode in the Council:	Unanimity (abstention is not counted as an opposing vote)

Formalities

Legal competency:	Art. 113 TFEU (Harmonisation of indirect taxes)
Form of legislative competency:	Shared competency (Art. 4 (1) TFEU)
Legislative procedure:	Special legislative procedure (the European Parliament is heard exclusively, Art. 289 (2) TFEU)

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

During the financial crisis several financial institutions managed to avoid having to assume liability for their own actions. This resulted in these institutions being able to enjoy high levels of state support measures. Therefore, the plan to involve the financial sector in bearing these costs and to prevent such crises in future deserves to be supported.

The financial transaction tax, however, is not the proper instrument for doing so. Although it might to a certain degree – depending on the volume of leaked transactions – create the projected revenues for the public purse and thereby fulfil the fiscal purpose of a tax, it **fails to achieve its steering function, namely to deter financial institutions from enacting risky business transactions and thus to prevent future crises**. **For it cannot systematically prevent** economically **harmful behaviour** by making it more expensive; **on the contrary, this would incur even greater damage**.

Firstly, there is no conclusive proof as to which financial transactions, employing which financial instruments and under which circumstances jeopardise financial stability. The FTT could only provide such stabilising incentives if such evidence existed.

The fact that for the FTT only **minimum tax rates are introduced could** even **jeopardise financial stability**. For Member States will use this room for manoeuvre to introduce different tax rates. This can lead to increased leakage in financial transactions and thus to a concentration within the EU. The interest of financial centres strengthened or created in this way in a reinforced financial market regulation is likely to be rather limited.

Secondly, the tax affects all market participants, including those who contribute to an efficient price-building and thus increase market efficiency. On the one hand, an FTT can be an appropriate instrument for reducing the attractiveness of high-frequency trading in which items are built and sold within minutes or even seconds, as the tax minimises or even eliminates the often low margins of this trade. However, this should not really be regarded positively, for it does not necessarily lead to a reduction in the volatility in markets. The tax would increase transaction costs and thus lead to a reduced number of market participants and to fewer potential business partners. As a result, single transactions could cause higher price fluctuations.

High-frequency trade often contributes to the elimination of market inefficiencies and thus optimises price building (so-called price arbitrage). Moreover, the increased incentives to hold financial instruments for longer also increases the capital costs, as investors will demand equivalent payment for the increased holding periods which, eventually, will reduce market actors' willingness to invest.

Thirdly, the tax could create damages, as it is levied not only upon transactions which allegedly jeopardise the

stability of the financial market, but also on derivative transactions to hedge risks and on other economically reasonable transactions, which would therefore become more expensive.

The financial transaction tax will therefore not increase the stability of the financial market and, hence, **does not contribute to preventing a new crisis in the banking sector.**

Even the Commission itself is not convinced by the FTT: "There is little evidence that the potential beneficial effects of a transaction tax outweigh the potential costs" (Impact Assessment Vol. 17, S. 8). Both the FTT and the financial activities tax would lead to higher tax revenues; however, with an FTT, the leakage risk would be much higher and the slowdown in growth and employment greater (Impact Assessment Vol. 1, S. 38).

Impact on Efficiency and Individual Freedom of Choice

The introduction of an FTT is related to efficiency losses. For instance, even the Commission itself expects "dead weight losses" of up to 200 billion Euros, which is much more than with the financial activities tax (Impact Assessment Vol.17 p. 4 and 5).

Impact for Growth and Employment

Higher capital costs resulting from the tax reduce willingness to invest, which leads to declining growth rates. Thus negative impacts on employment can also be expected. The Commission expects the gross domestic product to decline by 0.53% (Explanation p. 5, Impact Assessment Vol.1 p. 52).

Impact for Europe as a Business Location

The residence principle, whereby not the location of a transaction is relevant for taxation but the business seat of the parties to the transaction, reduces the risk of leakage which is associated with FTT. However, FTT increases the capital costs of companies active in the EU. This has a negative impact on the EU as a business location as long as the FTT is introduced in the EU only.

Legal Assessment

Legislative Competency

The EU harmonises the Member States' indirect taxes where this is necessary for the establishment and functioning of the internal market and to prevent distortion of competition (Art. 113 TFEU).

Subsidiarity

An EU-wide harmonisation of FTT would reduce the risk of FTT encouraging a leakage of financial transactions and an outsourcing of financial institutions within the Union to Member States without an FTT. However, this applies only to a limited extend where Member States make use of the available leeway with regard to implementation and fix different tax rates.

Proportionality

Unproblematic.

Compatibility with EU Law

States may impose taxes only if there is a close link between the matter taxed and the territory of the state concerned (so-called genuine link). This results from the territoriality principle, which is a general rule of international law and is therefore also binding for the EU. In fact, it is at the discretion of the legislator as to which connecting factor is chosen for taxation. However, **it remains questionable whether or not only the contract conclusion with a party from the EU suffices for taxation**. **The European Court of Justice will have to clarify this question**.

Compatibility with German Law

The general rules of international law prevail over the Basic German Law (Art. 25 p. 2 German Constitutional Law). With regard to the territory principle, the German Federal Constitutional Court held that the legal option of imposing taxes on foreigners is significantly restricted in view of the connecting factor. However, only a "minimum of understanding" is necessary to choose the right connecting factor. (BVerfGE 63, 343)

Possible Future EU Action

In the event that unanimity is not reached by the 27 Member States, at least nine Member States may introduce the FTT within the framework of a reinforced cooperation pursuant to Art. 20 TEC in conjunction with Art. 326 et sqq. TFEU. In so doing, the requirements of the Directive concerning indirect taxes on the raising of capital (2008/7/EC) must be complied with, as a reinforced cooperation must adhere to Union law (Art. 326 sub-para. 1 TFEU). The Commission Proposal amending the MiFID Directive [COM(2011) 656] contains a new definition of the term "financial instruments", according to which, in future, emission allowances are also to be deemed "financial instruments" of FTT.

Conclusion

Although the FTT achieves its fiscal target to a certain degree, it clearly misses its main objective. It cannot deter the financial sector from entering into risky business transactions, nor can it prevent future banking crises. The FTT can even jeopardise the stability of the financial markets, as minimum tax rates encourage the leakage of financial transactions within the EU. It is questionable whether a taxation of banks seated in third countries is even admissible at all.

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