

The EU Financial Transactions Tax Draft Directive and the Implications for the Global FS industry

This Newsflash provides an overview of the draft directive released by the EU Commission today which seeks to introduce the financial transactions tax (“FTT”) within the EU by a specified start date of 1 January 2014. It is also the intention of the EU to explore ways to introduce the FTT at a global level through the G-20. Our comments and observations of the potential impact of these new developments on the business community are provided below.

Background

In the wake of the global financial crisis in 2008 there were widespread calls for the introduction of additional taxes on the financial sector to ensure that the sector makes a fair and substantial contribution toward paying for the costs of the crisis and for any burden associated with future government interventions in the sector.

In response to a request by the G-20 leaders, in April 2010 the IMF conducted a study into potential additional taxes which might be imposed on the financial sector including a FTT. This study concluded that a “FTT does not appear well suited to the specific purposes set out in the mandate from the G-20 leaders” and appetite for the introduction of such a tax at a global level has been limited.

Notwithstanding this, the EU has continued to push for the introduction of a FTT and in March 2011 the European Parliament resolved that the EU should continue to promote the introduction of a FTT at a global level and, failing this, the EU should implement a FTT at a European level as a first step. As the euro-zone sovereign debt crisis has developed over the summer, the introduction of a FTT has also been identified by EU leaders as a key element of raising revenues for the European Union in the future and could be seen as a first step towards closer fiscal union amongst the Member States.

The release of the draft Directive today indicates that the EU Commission is committed to pressing ahead with introduction of a FTT at an EU level although it remains to be seen whether this commitment will be shared by all Member States.

The draft Directive

The principal features of the proposed FTT regime as outlined in the draft Directive are as follows:

Scope of transactions covered

The scope of transactions covered by the FTT will be wide and will include all transactions in financial instruments including equities, bonds, foreign currency (excluding spot contracts) and derivatives whether conducted on a regulated market or on an OTC basis. The transactions covered will include purchases and sales of financial instruments together with sale and repurchase (“repo”) and securities lending transactions. The FTT will apply to both transactions between third parties and intra-group transactions.

Taxable amount and rate

In the case of financial transactions other than derivatives, the taxable amount will be the consideration payable between the parties for the transfer of the financial instruments under the transaction. The taxable amount in relation to derivative transactions will be the notional principal amount specified in the contract at the time the derivative is entered into.

The draft Directive provides that the rate of FTT will be fixed by each Member State subject to a minimum rate 0.1% for financial transactions other than derivatives and 0.01% for derivatives.

Scope of persons within the charge to FTT

In order to concentrate the FTT charge on the financial sector (rather than citizens), it is proposed that the FTT will apply to any financial transaction undertaken by a “financial institution” established within the EU. The FTT charge will apply to the financial institution irrespective of whether it is acting in a principal or agency capacity.

The definition of “financial institution” for this purpose is broad and includes investment firms, organised markets, credit institutions, insurance and re-insurance institutions, collective investment schemes and their managers, pension funds and their managers, holding companies, leasing companies and special purpose vehicles.

Central Counterparties (CCPs), Central Securities Depositories (CSDs) and International Central Securities Depositories (ICSDs) where carrying on their respective functions will not be liable to the FTT. Transactions with the European Central Bank and national central banks will also be excluded from the scope of the FTT.

A financial institution will be deemed to be established in the territory of a Member State if it is authorised in that Member State, has its registered office in the Member State, is resident in the Member State or is acting through a branch located in the Member State.

Hence, where a financial institution established in a Member State is party to a financial transaction it will be subject to FTT irrespective of the location of the counterparty or the location of trading.

Compliance with FTT

The relevant financial institution will be liable to account for the FTT to the tax authority of its local Member State. Each Member State will be required to adopt measures in its local law to ensure that the FTT is payable immediately if the relevant financial transaction is carried out electronically and within three working days in all other cases. Member States will also be required to adopt measures to prevent evasion or avoidance of the FTT.

Timing

The draft Directive specifies a start date for the FTT regime of 1 January 2014.

Next Steps

In order to be implemented, the draft Directive needs to be discussed and agreed unanimously amongst the 27 EU Member States at the EU Council of Ministers.

The Commission also intends to continue to explore ways to introduce a FTT at a global level through the G-20.

The impact of the VAT exemption on financial services

In the press release today, the European Commission state that the financial services sector “is currently undertaxed by comparison with other sectors”. The main reason for this according to the EU, is that “the financial sector enjoys a tax advantage of approximately €18 billion per year because of VAT exemption on financial services”. However as the European Commission say themselves “these estimates are very rough approximations and should be interpreted with caution”. PwC would agree with this last comment mainly because the sector already pays a very significant amount of irrecoverable VAT and even if VAT were chargeable on financial services, business consumers would recover it (i.e. governments would not receive additional VAT). It is, in our view, too early to conclude that the VAT exemption represents a tax advantage and the issue needs further study. It is possible that such further study could reach the opposite conclusion (i.e. that the VAT exemption is not a tax advantage at all), in which case this justification for an FTT would be undermined.

PwC comments:

- **Policy v politics:** We believe the proposed FTT regime gives rise to a number of fundamental concerns at a tax policy level – in particular the distortive impact on financial market activity and the cost to final consumers – which led to the conclusion in the 2010 IMF study that a FTT was not the preferred mechanism for ensuring the financial sector makes a “fair and substantial contribution”. Whilst the potential impact of these may be mitigated if a FTT were to be introduced at a global level, the prospect of a global accord on the introduction of a FTT

appears remote. Implementation of a FTT at an EU level only would seem, if anything, to amplify these concerns. We believe there is a very real risk that these genuine tax policy concerns will be overtaken by the broader political agenda at play within the EU with the result that it could affect the competitiveness of the EU as a location for global financial services business.

- **Distortion of financial markets:** The introduction of the FTT would have a distortive impact on financial markets activities both in terms of location and nature. Specifically, it would encourage financial trading to be undertaken outside the EU amongst non-EU financial institutions. It would also discourage short term trading activity
- **Impact on financial institutions and consumers:** At a time when financial institutions within the EU are being encouraged to build up their capital base and when EU consumers are being encouraged to reduce personal debt and increase savings (which in many cases will be held in collective investment schemes and pension funds), it would seem counter-intuitive to introduce an additional tax which will impact adversely on both of these activities.
- **Disproportionate impact across the EU:** The FTT would have a disproportionate

adverse impact on certain EU Member States - the United Kingdom in particular would suffer given the City of London's position as a global financial centre. For this reason, achieving the unanimous agreement amongst the 27 EU Member States which would be required to introduce the FTT on an EU wide basis is likely to be difficult in practice. In view of this, a potential alternative outcome may see the FTT introduced at a euro-zone level which may put euro-zone FS institutions and domicilies at a competitive disadvantage and encourage switching of business outside the euro-zone

- **Inconsistent application within the EU:** Given that each Member State will be required to implement the FTT under its own local laws, there is a very real prospect that there will be inconsistent application of the regime amongst the different Member States which could lead to distortion of financial markets within the EU itself.
- **Compliance burden:** At a time when banks and other financial institutions are already having to deal with a huge array of additional compliance obligations imposed by the myriad of new financial sector regulatory measures, imposing further complex and costly compliance requirements in connection with the FTT will place further pressure on profitability across the sector.

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