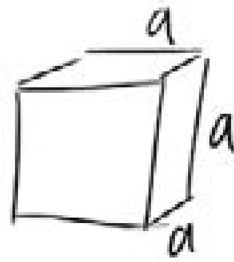
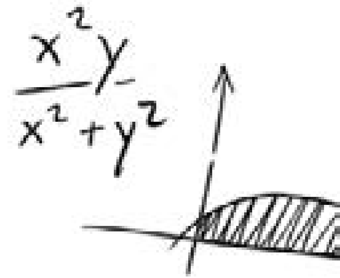
Tax perspective



$$\in(x) = \frac{1}{p},\ var(x) =$$



$$\frac{x^2 y}{x^2+y^2}$$

Investment Funds' performance and Financial Transactions Tax

An equation with multiple unknowns

Benjamin Collette
Partner
Advisory & Consulting
Deloitte

Eric Centi
Director
Tax
Deloitte

Manuela Abreu
Senior Manager
Tax
Deloitte

On 14 February 2013, the European Commission published its revised proposal for an EU Financial Transactions Tax (EU FTT)[1], which is expected to generate approximately €30 to 35 billion per year

This draft directive provides for the introduction of a tax on financial transactions at a minimum[2] rate of 0.1% for transactions other than derivatives and 0.01% for derivatives transactions[3]. While the FTT is proposed to enter into effect on 1 January 2014 (now possibly postponed to a later date due to UK's legal challenge against the FTT), the timetable will obviously depend on the European Council reaching an agreement on the proposal.

The introduction of an EU-wide financial transactions tax is likely to have a significant impact on fund industry performance and attractiveness. Below we detail the key characteristics of the Commission's proposal and its potential impacts as far as investment funds are concerned.

1 COM(2013) 71 final

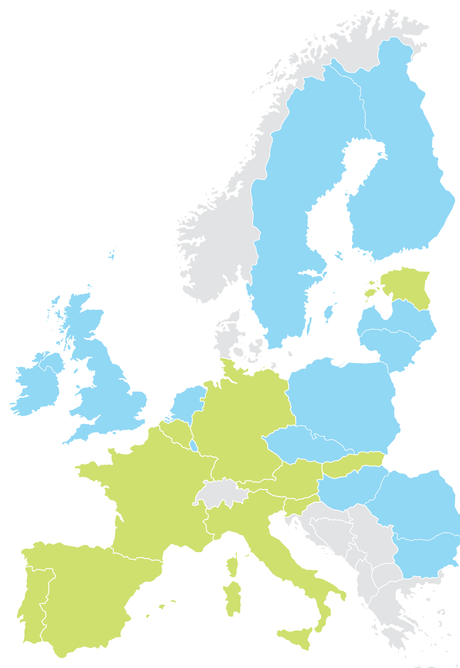
2 Participating Member States would be free to apply higher rates if desired

3 While the taxable amount would in principle be the consideration paid or owed from the counterparty for financial transactions other than those related to derivatives contracts, the taxable amount in case of financial transactions related to derivatives contracts would be the notional amount referred to in the contract

Background

From consensus to enhanced cooperation

The original draft directive[4] released by the European Commission in September 2011 gave rise to tensions between EU member states, which advocated diverging positions with respect to an EU-wide implementation of the tax. The difficulties in reaching a consensus within the EU led to the request, by a limited number of EU member states, to proceed using the so-called Enhanced Cooperation Procedure (ECP)[5]. The ECP is a procedure that allows a subset of at least nine member states to establish closer cooperation between themselves, without involvement from the other members states. The member states concerned can thus move forward at different speeds and/or towards different goals.



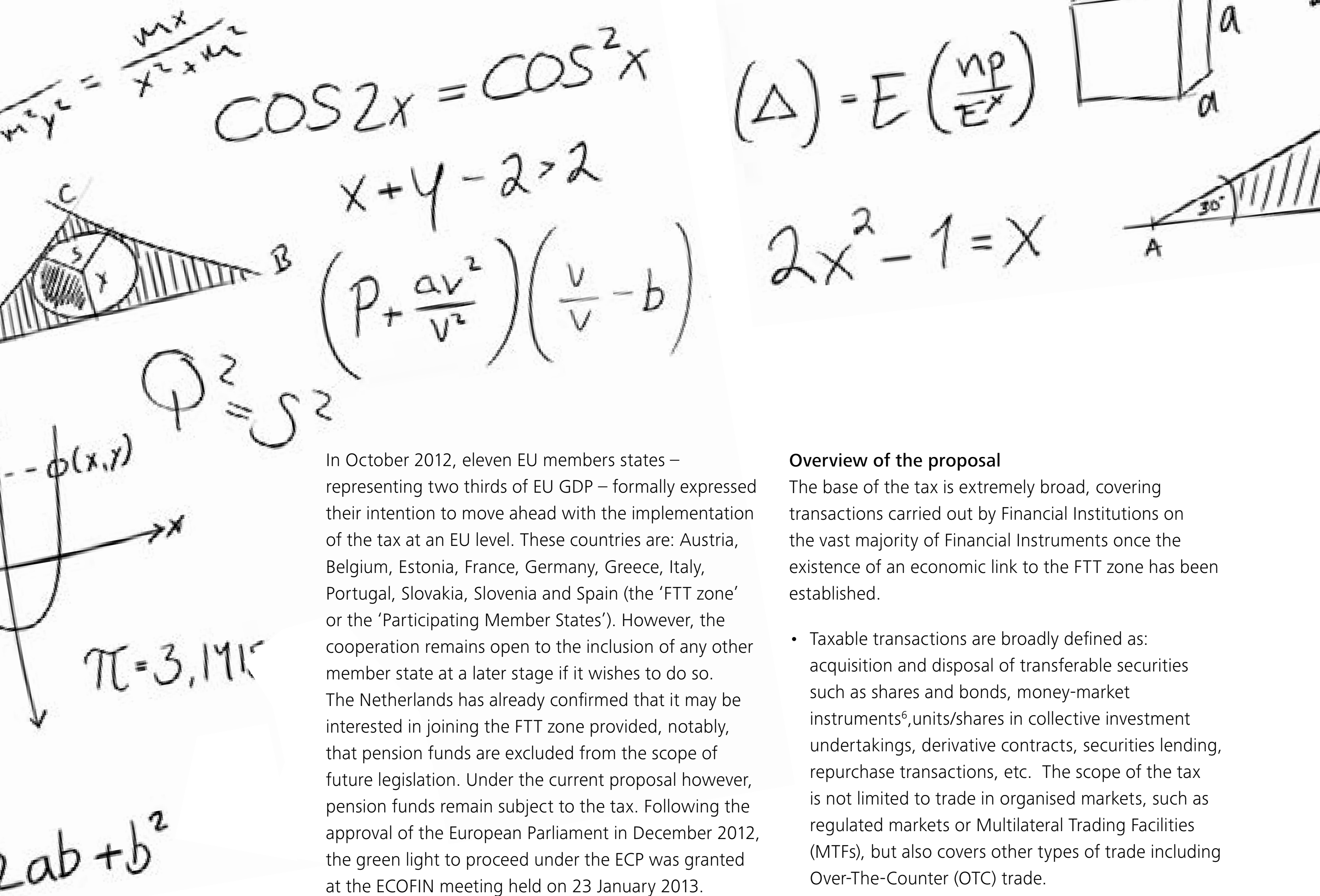
Participating Member States (FTT zone) as of today Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain

Non Participating Member States (Non FTT zone) as of today

Third countries

4 *COM(2011) 594 final. Please also refer to our previous article in Performance n°7 (January 2012): "Financial Transaction Tax – Something in the air", Raymond Krawczykowski and Dany Teillant*

5 *http://europa.eu/legislation_summaries/institutional_affairs/treaties/amsterdam_treaty/a28000_en.htm*



In October 2012, eleven EU members states – representing two thirds of EU GDP – formally expressed their intention to move ahead with the implementation of the tax at an EU level. These countries are: Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain (the 'FTT zone' or the 'Participating Member States'). However, the cooperation remains open to the inclusion of any other member state at a later stage if it wishes to do so. The Netherlands has already confirmed that it may be interested in joining the FTT zone provided, notably, that pension funds are excluded from the scope of future legislation. Under the current proposal however, pension funds remain subject to the tax. Following the approval of the European Parliament in December 2012, the green light to proceed under the ECP was granted at the ECOFIN meeting held on 23 January 2013.

The proposal has still to be reviewed and approved by the Participating Members (see below our comments regarding the UK's legal challenge). All 27 member states may participate in the discussions and the European Parliament will also be consulted.

Due to the fact that the UK Government lodged a formal legal claim at the ECJ, more doubts are casted on the likelihood of the EU FTT being introduced on 1 January 2014, as originally planned

Overview of the proposal

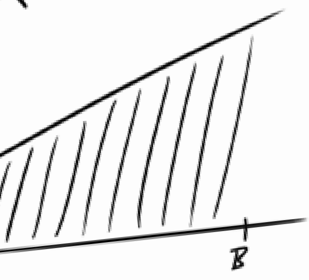
The base of the tax is extremely broad, covering transactions carried out by Financial Institutions on the vast majority of Financial Instruments once the existence of an economic link to the FTT zone has been established.

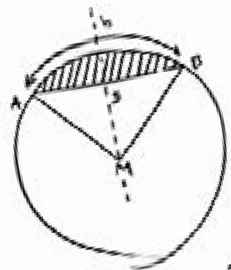
- Taxable transactions are broadly defined as: acquisition and disposal of transferable securities such as shares and bonds, money-market instruments[6],units/shares in collective investment undertakings, derivative contracts, securities lending, repurchase transactions, etc. The scope of the tax is not limited to trade in organised markets, such as regulated markets or Multilateral Trading Facilities (MTFs), but also covers other types of trade including Over-The-Counter (OTC) trade.

  The FTT will however not apply to day-to-day financial activities relevant for citizens and businesses such as lending, payments, insurance, deposits, spot currency transactions, etc. In order not to affect refinancing opportunities for financial institutions and member states, financial transactions with the European Central Bank, national central banks, the European Financial Stability Facility, European Stability Mechanism and the EU should also be excluded from the scope of the tax.

- The concept of a financial institution is also broadly defined and effectively includes banks, insurance and reinsurance undertakings, investment firms, collective investment undertakings – including UCITS and Alternative Investment Funds – and their managers, pension funds and their management companies[7]. Even holding companies and any other undertakings or even persons carrying out certain financial activities with a significant annual average value of financial transactions may be considered as Financial Institutions for FTT purposes[8].

  Central Counterparties (CCPs), Central Securities Depositories (CSDs), International Central Securities Depositories (ICSDs), member states and public bodies tasked with managing public debt are not in principle deemed to be financial institutions





- Finally, the territorial application of the proposed FTT is primarily based on the *residence principle*. In essence a financial transaction would be taxable provided that one of the parties to the transaction is established in a Participating Member State. The sale of shares by a French Bank to a German UCITS would then be subject to FTT on both sides of the transaction, i.e. in France (seller's side) and in Germany (buyer's side).

  Under the residence principle, financial transactions entered into by a financial institution located outside the FTT zone would not be subject to FTT, unless the other party to the transaction is established in the Participating Member States. The sale of shares by a UK Bank to a German UCITS would be subject to taxation twice in Germany: while the German UCITS would be liable to pay the FTT on the acquisition, the UK Bank would be deemed to be established in Germany for FTT purposes and would also be liable to pay the tax there.

  To further prevent avoidance of the tax, the EU Commission added the *issuance principle* to its proposal. Qualifying financial transactions entered into by two financial institutions both located outside the FTT zone would therefore be subject to taxation provided that they involve financial instruments issued in one of the Participating Member States. The sale of shares issued by a Belgian resident company between a UK Bank and US Bank would be subject to FTT twice in Belgium: indeed both parties to the transaction would be deemed to be established in Belgium for FTT purposes.

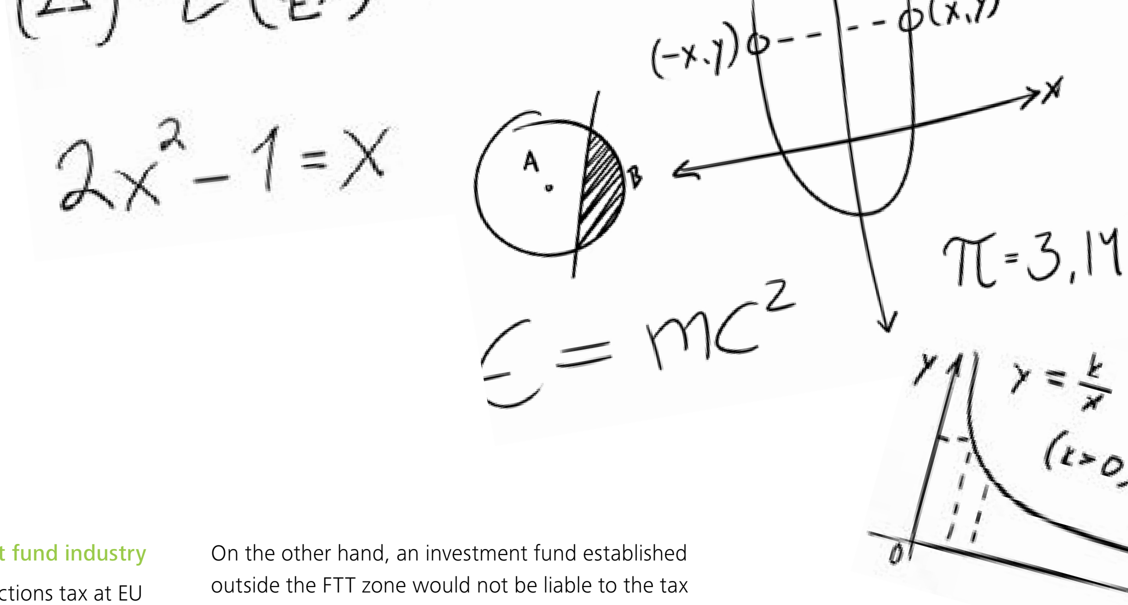
Most recently, on 18 April 2013, the UK Government lodged a formal legal claim at the European Court of Justice against the introduction of the EU FTT under the ECP. This claim is based on the grounds that the existing proposal will impact countries not taking part to the initiative. This legal challenge casts doubts on the likelihood of the EU FTT being introduced on 1 January 2014, as originally planned by the EU Commission.

The introduction of an EU-wide financial transactions tax is likely to have a significant impact on fund industry performance and attractiveness, where fund's domicile will clearly become a key differenciator

6 With the exception of instruments of payments

7 Article 2.1(8)

8 Article 2.1(8) j. The present proposal sets the threshold at 50% of its overall average net annual turnover of the entity/person concerned



A real challenge for the investment fund industry

The introduction of a financial transactions tax at EU level will likely have a great impact on the fund industry. Indeed, aside from the effect of the tax on portfolio transactions, the distribution of units/shares by funds would also be impacted. In this way, the domicile of the investment funds will potentially become one of the key drivers to be carefully considered by fund promoters.

At portfolio transaction level

An investment fund established in the FTT zone would be taxed on each qualifying financial transaction. On the other hand, an investment fund established outside the FTT zone would not be liable to pay the tax as long as the counterparties to the financial transactions are not established in a Participating Member State and the financial instruments traded are not issued in the FTT zone.

The impact of the tax on funds' investment portfolios will essentially depend on their Portfolio Turnover Rate (PTR). Typically money-market funds whose PTR is often higher than the average would be more impacted than long-term equity funds whose investment and trading strategy may in principle be less dynamic, causing the FTT to have an extremely uneven impact as most 'conservative' products would suffer from a higher tax rate than more aggressive ones.

At fund distribution level

The European Commission has extended the primary market exemption, meaning that the issuance of units/shares by investment funds would not be subject to the tax. However, the redemption of units/shares in investment funds would not be exempt as these transactions are not covered by the aforementioned exemption.

Consequently, any redemption of units/shares by an investment fund established in the FTT zone would be subject to taxation. The total effect of the tax would be even higher if the beneficial owners were institutional investors[9].

On the other hand, an investment fund established outside the FTT zone would not be liable to the tax at the time of redemption except when the investor – whether retail or institutional – is established in a Participating Member State.

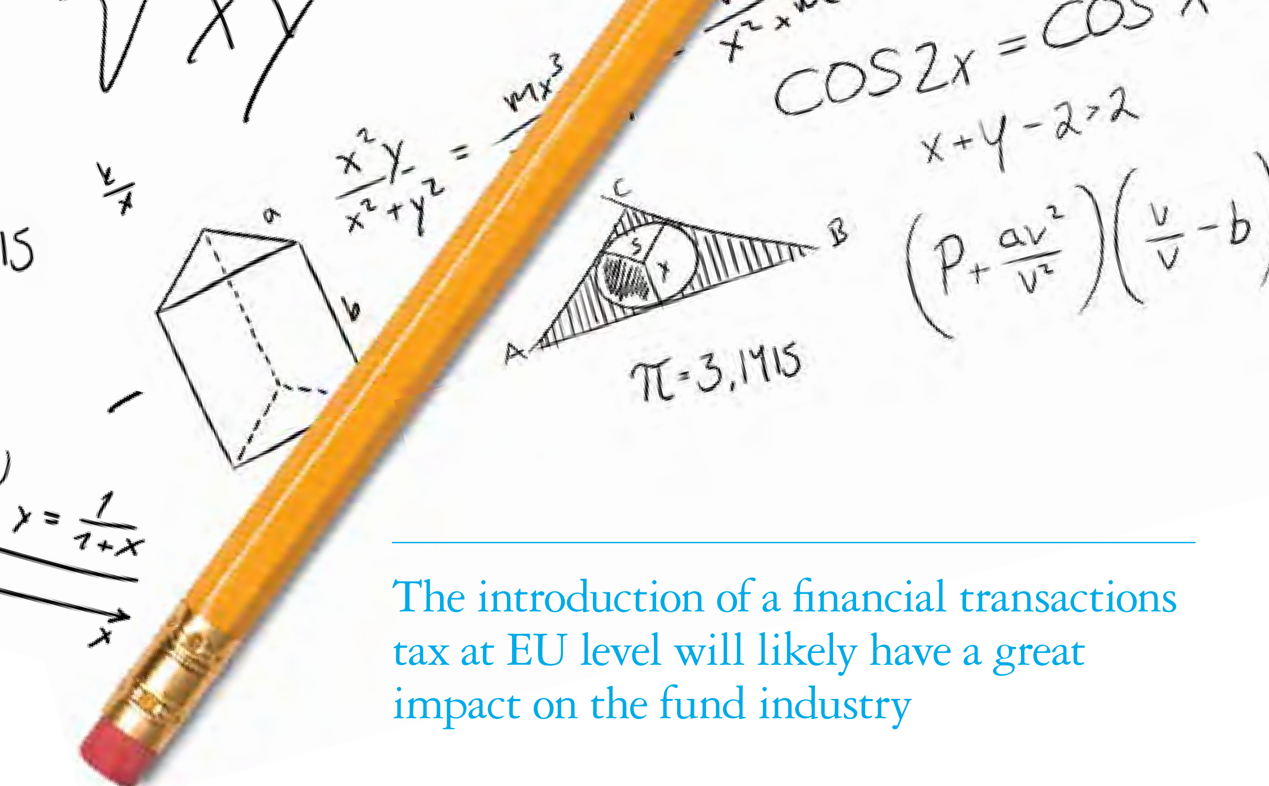
As a consequence, a Fund of Funds would potentially suffer from a cumulative effect caused by the FTT as they will be taxed at the level of the Master Fund portfolio as well as the Target Funds' investment portfolio for funds established within the FTT zone.

The overall cost of the FTT for UCITS investment funds will eventually be borne by fund investors through reduced fund performance and an 'exit tax' on redemption. This would have a very negative effect on vehicles that are designed and used for long-term retail investor savings. It would also be completely contrary to the original objective of the FTT, which was to reduce short-term speculative trading; identified as one of the accelerating factors in the financial crisis.

EFAMA's view

On the basis of the European Commission's original proposal, dated September 2011, EFAMA[10] estimated that the potential annual impact of the FTT on the UCITS industry[11] would have reached €38 billion if applied at the start of the year 2011. Following the release of the revised draft directive in February 2013, EFAMA published a new impact assessment[12] where the total impact of the FTT would have reached €13 billion assuming that the tax had been applied at the start of 2011, all other variables remaining unchanged.
This amount comprises €7.3 billion attributed to FTT zone countries and €5.7 billion attributed to the non-FTT zone.

	FTT on gross redemptions of units	FTT on total portfolio transactions	FTT total annual revenue
FTT ZONE	3,054	4,289	7,343
NON-FTT ZONE	1,235	4,448	5,683
TOTAL	4,289	8,738	**13,026**



The introduction of a financial transactions tax at EU level will likely have a great impact on the fund industry

However, derivatives transactions are not taken into account in this impact analysis, and EFAMA acknowledges that the potential impact of the FTT could be significantly higher as many UCITS use derivative instruments to cover their currency or market risks.

This new estimate released by EFAMA differs from its previous impact analysis for the following reasons which we have also detailed above:

- Portfolio transactions carried out by UCITS domiciled outside the FTT zone would not be subject to tax as long as the counterparties to the transactions are not established in a Participating Member State and that the transactions do not involve securities issued from the FTT zone
- The issuance of units/shares by UCITS would be exempt from tax under the primary market exemption
- EFAMA expects a lower FTT impact on redemptions of UCITS domiciled outside the FTT zone assuming that they are mainly distributed to domestic investors with the exception of Luxembourg domiciled UCITS, which according to EFAMA would be impacted to the extent they are distributed to investors based in the FTT zone
- Finally, EFAMA believes that the impact on portfolio management of money-market funds would be reduced due to the exemption of primary issuance

9 As long as the 'institutional investor' is considered as a 'financial institution' as defined by the Directive.

10 European Fund and Asset Management Association

11 http://www.efama.org/Publications/Public/FTT/EFAMA%20 impact%20analysis%20on%20Commission%20proposals%20 on%20FTT.pdf

12 http://www.efama.org/Publications/Public/130313_FTT_Impact_ Analysis_2013.pdf

Fund promoters and asset managers must follow the developments in relation to the EU FTT closely, as the current proposal is likely to impact the performance and the attractiveness of their fund products. In this respect, they must carefully consider where their funds are domiciled, analyse how their portfolio transactions are structured, revisit their investment strategy and also consider the risk that retail and institutional investors may move their savings to exempt products, such as savings deposits or life insurance products. This equation is not an easy one to solve, as there are various elements to be taken into account.

To the **point**:

- The introduction of a financial transactions tax at EU level will likely have a major impact on the fund industry
- The base of the tax is extremely broad, covering transactions carried out by Financial Institutions on the vast majority of Financial Instruments once the existence of an economic link to the FTT zone has been established
- The domicile of the investment funds will potentially become one of the key drivers to be carefully considered by the fund promoters
- Fund promoters and asset managers must follow the developments in relation to the EU FTT closely, as the current proposal is likely to impact the performance and attractiveness of their fund products