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FTT newsletter

A round-up of FTT developments across Europe

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We set out below 10 things we learnt about the proposed financial transaction tax ("FTT") from the responses provided by the Directorate General for Taxation and Customs Union ("Taxud"), a department of the European Commission (the "Commission"), to questions tabled by EU member states. Those who have followed the FTT process in detail and are familiar with the draft FTT Directive (the "Directive") will not be surprised by any of the responses, but Taxud's views affirm a number of concerns about the operation and impact of the FTT in practice if the Directive is introduced as currently drafted.

To discuss any aspect of FTT please contact your usual Deloitte contact or **Martin Walker** on +44 20 7303 7644.

EU FTT

In a "Non-paper" termed "Room Document #3", Taxud provides responses to questions tabled by 7 EU member states on how the FTT would apply in specific examples. Those member states were: the Czech Republic, Denmark, Germany, Finland, Slovenia, the UK and Ireland in its role as Commission President. This "non-paper" is for discussion purposes only and states on its face that it does not have legal status and has been provided for purely illustrative purposes. The next European Council working group for the FTT is scheduled for 22 May 2013.

1. Overnight repos – on the basis of the FTT as drafted, overnight repos in their current form (outright transfer of title) may become uneconomic and be replaced by pledges instead. In the example of an overnight repo over EUR 100 million of German bonds, carried out each day over a 250 day business year, the total FTT charge would be 25% of the notional value (i.e. EUR 25 million). It follows that after approximately 4 years the FTT charge would have eroded the entire value of the bonds – most likely sooner, in fact, as the financial institution may have to sell the bonds into the market to raise cash to pay the FTT on overnight repos, and that sale also triggers an FTT charge for the financial institution as seller. As an alternative, pledging the bonds, rather transferring them outright as is currently market standard, would not give rise to any FTT as no sale or transfer takes place (absent a default).

2. Central counterparties ("CCPs") - joint and several liability may mean that CCPs such as exchanges and clearers apply FTT to all transactions in practice. Financial institutions entering into transactions on an exchange or through a CCP or central securities depositary seem to be required to know the identity and location of the counterparty on the other side of the exchange in order to be able to ascertain whether they are (by virtue of their counterparty being established in the FTT zone) themselves liable to pay FTT. Where regulations such as the European Market Infrastructure Regulation ("EMIR") require a transaction to be cleared through a CCP, but the financial institution is not itself a member of that clearing or settlement system, then its transaction with a clearing member entity could give rise to multiple FTT charges on what is economically the same trade (the cascade effect of FTT). The CCP is itself exempt and looked through for FTT purposes. There is no indication in Taxud's answers of how market participants are expected to be able to identify their counterparty on the other side of an exchange, although it is clear that the CCP is jointly and severally liable for non-payment and Taxud suggests that CCPs may wish to withhold the FTT from all transactions in order to ensure it is collected and paid.

3. Passporting rights – may not necessarily lead to establishment in the FTT zone. A financial institution in a non-FTT zone country which is authorised under the Markets in Financial Instruments Directive ("MiFID") to carry out business in the FTT zone should not be treated as being established in the FTT zone provided that it does not operate in a participating member state. It should be noted that this answer by Taxud is not especially clear and the cross-references seem incorrect, but this may provide some relief for those concerned that every financial institution authorised under MiFID to act throughout the EU would automatically be treated as being established in the FTT zone owing to that regulatory authorisation.

4. Agency trades – agents are only exempt when on behalf of other financial institutions. The exemption for agents in Article 10(2) of the Directive only applies where a financial institution is acting as agent for another financial institution, in which case the other financial institution is liable for any FTT. A financial institution acting as agent for a non-financial institution remains subject to FTT. This also illustrates the seemingly arbitrary nature of the FTT, as whether the principal is a financial institution or not impacts the tax authority to which the FTT is paid, that of the agent's country or that of its principal, even though it is the end buyer of the financial instrument.

5. Daily margining – may not be subject to FTT. For reasons which are not entirely clear, Taxud's answer suggests that daily movements of collateral (e.g. to cover exposure under a stock loan or a derivative) would not be subject to FTT. This will no doubt need to clarified and tested in more detail, as daily movements of collateral to ensure sufficient margin is posted could result in an enormous charge to FTT.

6. There will always be a territorial link with the FTT zone where financial instruments are issued in the territory of a participating member state. If financial institutions or non-financial institutions are able to demonstrate that there is no link between the economic substance of a transaction and the territory of a participating member state then they shall not be deemed to be established in the FTT zone. Taxud does not expect financial institutions to be able to demonstrate the absence of a territorial link with the FTT zone if the transaction involves securities (including derivatives) issued in a participating member state, however. This would mean that this potential exemption from the FTT where there is no territorial link with the FTT zone could only apply if the charge arose owing to one or more of the parties being or being treated as being established in the FTT zone. It is not currently clear what evidence would be sufficient to demonstrate this; the burden of proof in this case would be on the financial institution.

7. Derivatives – the underlying asset or reference obligation of a derivative does not affect the "establishment" of either party to that derivative. By way of example, a derivative trading on a platform in the UK which has French shares as its underlying reference asset is not within scope to the FTT when the derivative is bought and sold by two parties neither of which is established in the FTT zone.

8. Derivatives – FTT is payable by reference to the notional value even if the market value is quite different. The Directive clearly states that where a derivative has more than one notional value, the higher amount should be used. More positively, FX swaps constitute one single transaction for FTT purposes, rather than one sale and purchase of one currency and one sale and purchase of the other. Where both parties to the swap are financial institutions then it is clear that each will be subject to FTT.

9. Double taxation may apply. FTT applies in addition to any other local transaction taxes, such as UK stamp duty reserve tax or Taiwanese transaction tax. This is also the situation under Italian FTT, where certain Italian shares listed in Hong Kong are subject to both Hong Kong stamp duty and Italian FTT.

10. Payment and collection – participating member states will need to specify registration, accounting, reporting and other FTT obligations. This may involve mutual assistance by tax authorities in non-participating member states. However, in accordance with the draft FTT Directive, the Commission may implement a framework for "uniform methods of collection". The Commission is still examining the possibility of "central tax collection" through trading venues or other market participants. UK stamp duty reserve tax, which is auto-debited by CREST (Euroclear UK and Ireland), the UK's central securities depositary or French FTT, which is levied on brokers and custodians, could potentially be used as a precedent in this regard.

In a separate "non-paper", "room document #4", the participating member states have requested clarification from the Commission in relation to certain aspects of the FTT. These requests include what is meant by a sale and purchase of financial instruments, how the tax would be collected (including how it would be collected from non-participating member states), how the joint and several liability principle might work, how the FTT charge on government bond transactions would impact the cost of national debt, the impact on the repo markets and the impact on high frequency trading activities.

We would expect that the participating member states would wish to understand all of these issues fully prior to proceeding with the introduction of an FTT (indeed one may have expected that these questions should have been asked by participating member states prior to voting to go ahead with FTT). This may indicate that there is still some way to go before the participating member states will be ready to introduce FTT, which places further pressure on the 1 January 2014 start date which already appears ambitious.

We will of course keep you updated with developments in this area through our regular FTT newsletters.

A list of Deloitte's **FTT contacts** across Europe can be found here along with a link to the **FTT website**.

Martin

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