

HONG KONG TAX ALERT

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European Commission issues proposals for a financial transactions tax

In February 2013, the European Commission published proposals for a financial transaction tax (FTT). Only 11 of the 27 member states of the European Union (EU) will participate in the FTT, including Germany, France, Italy and Spain.

Background

FTT is a tax payable by financial institutions on transactions in financial instruments, including derivatives. All financial institutions in the FTT zone will be liable, but those outside the FTT zone (e.g. London) will also be liable if dealing with counterparties in the FTT zone or in a security issued in the FTT zone. The current proposals are very broad with few exemptions, and with its significant extraterritorial reach, will be of concern to many countries.

FTT is expected to have a significant impact and expose both financial institutions, and their end customers, to multiple layers of taxation. Some lines or businesses (e.g. high frequency trading) may become uneconomic and others will need to be restructured. Trading volumes (and therefore liquidity and the bid/offer spread) in FTT zone-issued securities are likely to be adversely affected. There will be significant costs for end-users seeking exposure to FTT zone securities. This is damaging for both issuers and investors, both in terms of the direct cost, but also in terms of a reduction in overall yield for FTT zone asset allocations. In particular, pension funds are likely to be adversely affected.

The Commission has proposed a commencement date for FTT of 1 January 2014. This only gives financial institutions a very short window to assess the impact on business models and pricing and develop systems to account for and pay the tax. The challenge is significant and while the current proposals may be refined by member states, businesses should start preparing now.

Details

The concept of a FTT was initially introduced in 2011 for all 27 EU countries after the proposal failed to win the backing of the G20. A significant push-back from many members has led to this revised proposal based on a smaller number of countries. Many of the original attributes of the proposed FTT remain the same, but the scope of the tax has been broadened to try and limit avoidance by moving trading activity outside the FTT zone.

Many of these latest EU FTT proposals were in line with expectations on key issues:

- The minimum rate of tax is unchanged at 0.1 percent (0.01 percent for derivatives)
- Tax is payable by financial institutions, regardless of whether their counterparty is itself exempt from paying the FTT (see below for exemptions). Financial institutions are broadly defined to include banks, investment firms, pension funds, insurance entities, undertakings for collective investment in transferable securities (UCITS) and alternative investment funds (AIF).
- Taxability is governed by two principles, 'residence' and 'issuance'
 - The residence principle will catch transactions involving:
 - Entities which are incorporated, regulated, tax resident, or have a branch in the FTT zone.
 - Non FTT zone entities dealing with a FTT zone entity (e.g. this will catch all trades between UK entities and entities treated as established in the FTT zone under any of the tests, including trading with branches of an FTT zone entity).
 - This includes transactions between two separate financial institutions within the same group (i.e. intra group transactions) where at least one is resident in the FTT zone.
 - A subsidiary of a FTT headquartered entity located outside the FTT zone is treated like any other entity in the same country.
 - The issuance principle will catch:
 - Securities or listed derivatives issued or deemed to be issued in the FTT zone – theoretically wherever traded.
- The principle of joint and several liability of all parties to a transaction has been preserved – which in practice means that if one counterparty refuses to pay the FTT, the other counterparty could find itself held liable for both sides of the tax (e.g. where both counterparties are not in the FTT zone, but are trading in a FTT issued security).
- Certain institutions (central counterparties (CCP) and clearing houses as well as central banks and similar EU institutions) are exempt, though if a financial institution clears or settles through a CCP located in the FTT zone the financial institution will then itself be subject to the FTT.
- The only full exemption from the FTT is for primary market transactions (i.e. share issues, lending transactions and entering into insurance contracts, UCITs and AIF unit issues).

One significant new proposal is the inclusion of a broadly drafted anti-abuse rule, and a provision aimed specifically at the use of depositary receipts to avoid FTT on FTT zone issued securities. The depositary receipt provision proposes that authorities look at the essential purpose of the depositary receipts and whether they are primarily for the purpose of FTT avoidance. Trades in these instruments regardless of the residence of the counterparties, would then be subject to the FTT.

Next steps

Participating member states must agree to the draft directive and implement the directive under local law; the deadline for this is 30 September 2013.

While it is possible that the directive could be subject to significant revision or a delay in implementation, financial institutions should start planning now for a commencement date of 1 January 2014 for the FTT in its current form.

Details of the [proposals](#) are available here.



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