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# The Impact of Financial Transaction Tax on Companies - A Discussion

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Research Papers

# The Impact of Financial Transaction Tax on Companies - A Discussion

Carmel Said Formosa  $\pm^*$

## Abstract

In February 2013, eleven Member States agreed to adopt the Commissions' Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM (2013)71 final. This article reviews three thematic areas frequently discussed by practitioners and academia alike on the impact that the Proposal could have on companies operating within participating Member States. This includes the impact on capital and related costs, business strategy and compliance considerations. I ask the question whether the unintentional repercussions could be mitigated by making adjustments to the current Proposal including the expansion of exemptions and the adoption of an implementation framework that takes inspiration from the Value Added Tax System that is already implemented across Member States.

**Keywords:** Financial Transaction Tax, Transaction Taxes, Cost of Capital, Tax Burden, Compliance and Administration,

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## 1. Introduction

### 1.1. Background

Since 2008, the financial crisis has had a damaging effect on a number of economies around the globe. Much pressure has been placed on authorities to find a solution to the underlying causes of the financial crisis and take positive steps to avoid a repetition of the past. Although the financial sector carried much of the blame, there were many factors which contributed to the financial crisis.<sup>1</sup> Many argue that the financial crisis was fuelled by excessive leverage and the property bubble.<sup>2</sup> Others note the effect of executive compensation which encouraged risk taking, the lack of sufficient regulation and supervision<sup>3</sup> and legislation that may have encouraged short term bias towards debt.<sup>4</sup> Presently, we still find ourselves asking why questionable tax policy has not be abolished.<sup>5</sup> Furthermore, the increase in lending credit, financial liberalisation, opacity and complexity may also have had a significant impact and are issues which require monitoring even today.<sup>6</sup>

Whilst we find a number of individual country initiatives for improved regulation and fiscal reform, the European Union (EU) has pushed for a unified approach amongst Member States. The EU felt strongly that it should 'lead efforts to set a global approach [...] with a view to maintaining a world-wide level playing field'.<sup>7</sup> In 2010,<sup>8</sup> after reviewing a number of alternative ways to potentially regulate the financial sector (see Section 1.2.), an overwhelming majority of Member States voted in favour of outlining a proposal for a financial transaction tax (FTT).<sup>9</sup>

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<sup>1</sup> European Parliament resolution of 20 October 2010 on the financial, economic and social crisis: recommendations concerning measures and initiatives to be taken (mid-term report), 2009/2182(INI), P7\_TA(2010)0376.

<sup>2</sup> Hemmelgarn, T., & G. Nicodème (2010): 'The 2008 Financial Crisis and Taxation Policy'. Taxation Papers. European Commission, Working Paper, 20.

<sup>3</sup> G-20. The official communique issued at the close of the G20 London Summit. 2 April 2009. Available at: [http://eu-un.europa.eu/articles/fr/article\\_8622\\_fr.htm](http://eu-un.europa.eu/articles/fr/article_8622_fr.htm)

<sup>4</sup> OECD Discussion Note (2011): 'Promoting Longer-term investments by institutional investors: Selected issues and policies'. EUROFI High Level Seminar Organised with the French Presidency of the G20, Paris, 17-18 February.

<sup>5</sup> Alworth, J., & G. Arachi (2010): 'Taxation and the Financial Crisis'. In European Tax Policy Form, Institute for Fiscal Studies Conference.

<sup>6</sup> Claessens, S., & L. Kodres (2014): 'The Regulatory Responses to the Global Financial Crisis: Some Uncomfortable Questions'. Research Department and Institute for Capacity Development, IMF Working Paper, WP/14/46.

<sup>7</sup> European Council (2010): EUCO 13/10, Conclusions of 17 June 2010. General Secretariat of the Council. p 7.

<sup>8</sup> European Parliament resolution of 10 March 2010 on financial transaction taxes – making them work. P7\_TA(2010)0056.

<sup>9</sup> European Parliament resolution of 8 March 2011 on innovative financing at global and European level, 2010/2105(INI), P7\_TA(2011)0080.

Based on the polluter should pay principle,<sup>10</sup> the first proposal for a financial transaction tax was presented in 2011,<sup>11</sup> shortly after the G-20 Toronto summit held in 2010.<sup>12</sup> Not all Member States agreed on the introduction of an EU-wide transaction tax on financial instruments.<sup>13</sup> As conflicts persisted, this prompted a call for last resort measures<sup>14</sup> which set in motion the procedure for enhanced cooperation amongst willing Member States.<sup>15,16</sup> In 2013, the Council Directive for implementing enhanced cooperation binding participating Member States, was published,<sup>17</sup> herein referred to as the Proposal. The Proposal has been called a ‘milestone in global tax history’<sup>18</sup> and brings together eleven participating Member States<sup>19</sup> that seek to adopt FTT through enhanced cooperation procedure.<sup>20,21</sup>

The objectives of the Proposal focus on three core areas.<sup>22</sup> Firstly, it seeks to prevent fragmentation of the single market that could arise from uncoordinated approaches amongst Member States to tax the financial sector. Secondly, the Proposal seeks to ensure that the financial sector makes a fair and substantial contribution to public finances. Thirdly, the Proposal aims to discourage market transactions that do not contribute to the efficiency of financial markets or to the real economy.

The Proposal has found wide support from Oxfam,<sup>23</sup> various non-governmental

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<sup>10</sup> Dietlein, G. (2012).

<sup>11</sup> Commission Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC Brussels, 28.9.2011, COM(2011) 594 final.

<sup>12</sup> The G-20 Toronto Summit concluded that that financial reform must ensure that the financial sector make a ‘fair and substantial contribution towards paying for any burdens associated with government interventions’ See The G20 Toronto Summit Declaration, Toronto, June 27, 2010. Available at: <http://www.g20.utoronto.ca/2010/to-communicate.html>.

<sup>13</sup> Council of Europe, 3178th Council meeting Economic and Financial Affairs Luxembourg, Press Release 1682/12. 22 June 2012.

<sup>14</sup> Article 20(2) Treaty on European Union (TEU).

<sup>15</sup> European Parliament ‘Eleven EU countries get Parliament’s all clear for a financial transaction tax’. Plenary Session Press release - Economic and monetary affairs, 12 February 2012.

<sup>16</sup> The concept of enhanced cooperation was first introduced by the Treaty of Amsterdam, 1997 and was later simplified by the Treaty of Nice, 2001. In 2007 the Treaty of Lisbon helped to further improve cooperation between Member States. The legal basis for enhanced cooperation today is provided for both in Article 20 of the TEU and Articles 326 to 334 of the Treaty on the Functioning of the European Union (TFEU).

<sup>17</sup> Commission Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM (2013) 71 final of February 14, 2013.

<sup>18</sup> Šemeta, A. (2012): ‘The Financial Transactions Tax: Europe Needs It’. World Commerce Review.

<sup>19</sup> Austria, Belgium, France, Estonia, Italy, Germany, Greece, Portugal, Slovakia, Slovenia and Spain.

<sup>20</sup> Commission Proposal for a Council Decision authorising enhanced cooperation in the area of financial transaction tax Brussels, 25.10.2012 COM(2012) 631 final/2.

<sup>21</sup> This is made possible since the minimum participation required by the TEU has been acceded. See Article 20(2), TEU.

<sup>22</sup> The objectives were first outlined in the Commissions initial Proposal, COM(2011) 594 final. The general objectives for enhanced cooperation remained the same, See COM(2013) 71 final.

<sup>23</sup> Oxfam International (2013): ‘Oxfam salutes European Parliament’s vote of confidence for an ambitious Financial Transaction Tax’. 3 July. Available at: <http://www.oxfam.org/en/eu/pressroom/reactions/oxfam-salutes-european-parliaments-vote-confidence-ambitious-financial>.

organizations,<sup>24</sup> trade unions,<sup>25</sup> academics<sup>26</sup> and European citizens.<sup>27,28</sup> While those in favour of the Proposal see FTT as a tax instrument that could help to stabilize markets and reduce the likelihood of future crises, opponents fear that it may lead to a loss in trade, employment and growth and negatively affect the financial sector.<sup>29</sup> Banks and financial institutions have particularly voiced their concern that higher trading costs invoked by FTT may negatively affect their ability to compete internationally.<sup>30</sup>

In the light of the Commission's stand to encourage greater harmonisation on financial transaction taxes and prevent uncoordinated approaches within the European Union, it is interesting to note the number of Member States that do in fact charge transaction taxes on financial instruments. Table 1 shows that a total of twelve Member States do implement transaction taxes on financial instruments, of which only six are signatory to the enhanced cooperation agreement for FTT. This conflicts to some extent with their decision not to support the Proposal. There exists, however, a number of differences between transaction taxes found in Member States and the Proposal itself; in terms of scope, tax rate and design, which makes choosing FTT far from straightforward.<sup>31</sup> The lack of harmonisation that is found within the European Union distorts the internal market and creates opportunities for tax arbitrage. These issues underpin the concerns of the Commission, and support the use FTT as a tax instrument in the most harmonised way possible. Although these facts give impetus to a harmonised approach to FTT, and make us question if FTT could be prelude to a global tax,<sup>32</sup> this is unlikely

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<sup>24</sup> PSI signs on letter with recommendations to new World Bank president Re: Financial transaction taxes as a source of innovative finance, addressed to Dr. Jim Yong Kim President of the World Bank, October 05, 2012, Available at: <http://www.world-psi.org/en/psi-signs-letter-recommendations-new-world-bank-president>.

<sup>25</sup> Henkow, O. (2012): 'The Commission's Proposal for a Common System of Financial Transaction tax: A Legal Appraisal'. EC Tax Review 21/1, 5-16.

<sup>26</sup> Open Letter In Support of Financial Transaction Taxes, Centre for Economic and Policy Research, to whom it may concern, 3 December 2009. Available at: <http://www.cepr.net/index.php/publications/reports/economists-support-fft/>.

<sup>27</sup> 65% of EU citizens supported a tax on financial instruments. See European Commission (2011): 'Public Opinion in the European Union, Europe's Perception of the State of the Economy'. Standard Eurobarometer 75 / Spring – TNS opinion & social.

<sup>28</sup> A survey carried out by Oxfam found that more than twice as many people supported FTT than those that opposed it in UK (51% vs 19%), Germany (53% v 24%), France (51% v 22%), Spain (67% v 15%) and Italy (59% v 18%). In the Netherlands 38% were in favour and 25% were opposed. See Oxfam (2011): 'YouGov poll for Oxfam in UK, Germany, France, Spain, Netherlands and Italy'. Undertaken 7th – 14th March 2011.

<sup>29</sup> See House of Lords, EU Economic and Financial Affairs Sub-Committee, Financial Transaction Tax: an update evidence. Tuesday 19 March 2013. Available at: <http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/FTTEnhancedScrutiny/FTTScrutinyupdatesEvidence.pdf>.

<sup>30</sup> AIMA Research Note (2002): 'Financial Transaction Tax, An Assessment of the European Commission's Proposed Financial Transaction Tax,' Alternative Investment Management Association.

<sup>31</sup> Current transaction taxes across Member States vary and reflects the individual Member States' own particular fiscal policy and objectives. There are differences in terms of the treatment of transactions between groups, whether transaction taxes are charged in the case of mergers and acquisitions, and the scope of exemptions and deductions. Tax rates also vary.

<sup>32</sup> European Commission. Proposal for a Council Regulation of 9 November 2011 on the methods and procedure

occur.<sup>33,34,35</sup> The Proposal, however, could potentially have a positive domino effect on other countries which may be inspired by the Commission's initiative. As more and more countries seek to introduce transaction taxes on financial instruments, for regulatory or revenue purposes, or both, they may feel justified in doing so on the back of the initiative taken by the Commission. The Proposal may therefore achieve its objective indirectly, even if in a piecemeal way.

Table 1 –Transaction taxes on shares in EU Member States<sup>36</sup>

Member State	Transaction Tax	Capital Duty*
Austria†	-	√
Belgium†	√	-
Bulgaria	-	-
Croatia	-	-
Cyprus	√	√
Czech Republic	-	-
Denmark	-	-
Estonia†	-	-
Finland	√	-
France†	√	√
Germany†	-	-
Greece†	√	√
Hungary	-	-
Ireland	√	-
Italy†	√	-
Latvia	-	-
Lithuania	-	-
Luxembourg	-	-
Malta	√	√
Netherlands	-	-
Poland	√	√
Portugal†	√	-
Romania	-	-
Slovakia†	-	-
Slovenia†	-	-
Spain†	√	√
Sweden	-	-
United Kingdom	√	-

for making available the own resource based on the financial transaction tax. COM (2011)738 final, 2011/0334 (CNS).

<sup>33</sup> Pomeranets, A. (2012): 'Financial Transaction Taxes: International Experiences, Issues and Feasibility'. Bank of Canada Review, Autumn, 3-13.

<sup>34</sup> AIMA Research Note (2012).

<sup>35</sup> Meussen, G. (2011): 'A New Tax Strategy for the European Union: FTT and FAT, Realistic or a Bridge too Far?'. 51 Eur. Taxn. 2/3 Journals IBFD.

<sup>36</sup> Source: IBFD (2013): 'European Tax Handbook.' Global Tax Series, IBFD.

\* Capital duty may refer to both duty payable on formation as well as duty on the issuance of shares. It has been included here to highlight other taxes that may be due on the transfer of financial instruments.

† Participating Member States to enhanced cooperation agreement.

## 1.2. Alternatives to Financial Transaction Tax

The Commission has undertaken a number of discussions on how best to tax the financial sector. Discussions focused on selecting the appropriate tax instrument that could generate sufficient revenues and provide the appropriate steering effects. Such an instrument would need to focus on ‘value added’, be ‘non-distortive’, yet still meet ‘equity objectives’.<sup>37</sup> A number of alternatives were discussed including Financial Activity Tax (FAT), Financial Stability Contribution (FSC) and Value Added Taxation (VAT).<sup>38</sup> Each alternative tax instrument is discussed hereunder, in the light of the Commission’s choice to continue with FTT as its preferred means to tax the financial sector, which is discussed in detail in Section 1.3.

FAT is a form of bank levy which is charged on ‘the sum of the profits of financial institutions and the remuneration paid by them’.<sup>39</sup> The IMF<sup>40</sup> proposed three variants of FAT, – FAT 1 based on a VAT like system without the right to deduct wages, FAT 2 which taxes financial sector rents and FAT 3 based on risk taking.<sup>41</sup> Like FTT, FAT is Pigovian in nature and seeks to curb excess<sup>42</sup> and does so by increasing costs proportionately. This, however, arises independently of the source of revenue generation.<sup>43</sup> As a result, FAT is criticized for not having the appropriate steering effects<sup>44</sup> as it is unable to ‘reorient market trading behaviour’.<sup>45</sup> Some argue that FAT could be modified to make it more appropriate as a tax instrument for regulating the financial sector.<sup>46</sup> Although a risk taking FAT could tackle risk,<sup>47</sup> measures that are more ‘closely linked to the sources of systemic risk might be more

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<sup>37</sup> Claessens, S., M. Keen, & C. Pazarbasioglu, eds. (2010) p. 20.

<sup>38</sup> Other alternatives include securities transaction taxes (STT) and global solidarity levy.

<sup>39</sup> Staff of the International Monetary Fund (2010): ‘A Fair and Substantial Contribution by the Financial Sector – Final Report for the G-20’. IMF. p. 5.

<sup>40</sup> In its report, the IMF outlines three alternative versions of the FAT, namely (i) the addition-method FAT, (ii) the rent-taxing FAT and (iii) the risk-taxing FAT. The report states that whereas the addition method taxes all profits and remuneration, the rent-taxing method taxes profit only above a certain amount, calculated based on the application for an allowance for corporate equity. Risk-taxing FAT is a step above rent-taxing FAT and focuses on excessive return. Staff of the International Monetary Fund (2010).

<sup>41</sup> See Shaviro, D. N. (2012): ‘The Financial Transactions Tax vs. The Financial Activities Tax’. Tax Analysts, Special Report, 453-474, for an in-depth analysis of all three proposals made by the IMF.

<sup>42</sup> Some argue that the lack of specificity in FTT makes the latter fall short of being Pigovian in nature. See Kaiding, J. (2014): ‘The Financial Transaction Tax: The Way Forward for the European Union?’. EC Tax Review, 1, 30-42.

<sup>43</sup> COM(2010) 549 final.

<sup>44</sup> Kavelaars, P. (2012): ‘Bank Taxes in Forms and Sizes: EC Opts for FTT’. Intertax 40, 6/7, 400-407. p. 404.

<sup>45</sup> Buckley, R., & G. North (2011): ‘A Financial Transactions Tax: Inefficient or Needed Systemic Reform?’ University of New South Wales Faculty of Law Research Series 2011. Working Paper 56.

<sup>46</sup> Shaviro, D. N. (2012).

<sup>47</sup> Commission Staff Working Paper of 28 September 2011, Impact Assessment Accompanying the document Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC Vol. 1, SEC(2011) 1102 final.

appropriate'.<sup>48</sup> In this way it can help to deter speculation, noise trading, as well as technical trading and also reduce markets volatility.<sup>49</sup> FAT, however, lacks specificity in its focus on speculative trading, a key issue in the debate on the introduction of FTT.<sup>50</sup> FTT seems to provide more focus in this respect as it focuses primarily on financial instruments (see Section 1.3.), even if this objective may be difficult to achieve in practice (see Section 2.2.3.)

Estimates show<sup>51</sup> that FAT could generate approximately €25 billion in tax revenues within the 27 EU Member States,<sup>52</sup> far less than the €31 billion<sup>53</sup> that could potentially be generated by FTT under enhanced cooperation. However, an advantage of FAT over FTT is that the former is easier to implement<sup>54</sup> and potentially more efficient.<sup>55</sup> Global harmonisation in all cases would reduce distortions.<sup>56</sup> But while FTT is criticized that it may lead to relocation of financial institutions (see Section 2.2.2.), FAT may encourage profit shifting as a means to reduce the tax burden without relocation taking place.<sup>57</sup> GDP will therefore be negatively affected in both cases.<sup>58</sup>

FAT and FTT were not the only measures considered by the Commission as alternatives to regulate the financial sector. Other considerations included FSC which focuses on a company's balance sheet and is linked to a 'credible and effective resolution mechanism'.<sup>59</sup> In contrast to FTT, it reflects a levy on banks, focusing on the institution rather than on the financial instrument being traded. In this respect FSC is similar to FAT. The IMF in fact proposed that FSC be introduced alongside FAT.<sup>60</sup> FSC, if appropriately designed does however provides an advantage for policy makers over FAT. It can provide greater focus on key issues that need to address as part and parcel of tax reform in a post financial crisis

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<sup>48</sup> Commission Staff Working Paper Executive Summary of the Impact Assessment Accompanying the document Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC, SEC(2011) 1103 final. p. 5.

<sup>49</sup> SEC(2011) 1103 final.

<sup>50</sup> In practice it may be difficult to limit FTT to trading which is purely of a speculative nature.

<sup>51</sup> Communication from the Commission to the European Parliament, The Council, the European Economic and Social Committee and the Regions, Taxation of the Financial Sector, Brussels, 7.10.2010 COM(2010) 549 final.

<sup>52</sup> Commission estimates based on IMF report See Claessens S., M. Keen, & C. Pazarbasioglu (2010): 'Financial Sector Taxation, The IMF's Report to the G-20 and Background Material'. IMF.

<sup>53</sup> Explanatory Memorandum to COM(2013) 71 final.

<sup>54</sup> Leading Group (2010): 'Globalising Solidarity: The Case for Financial Levies'. Report of the Committee of Experts to the Taskforce on International Financial Transactions and Development. Leading Group on Innovating Financing for Development. Paris.

<sup>55</sup> Vella, J. (2012): 'The Financial Transaction Tax Debate: Some Questionable Claims'. In The Financial Transaction Tax – Boon or Bane? Intereconomics, 2012/2, 90-95.

<sup>56</sup> Soone, A. (2014): 'Some Legal Issues with Implementing Commission Proposed Financial Transaction Tax in Estonia'. Intertax, 42/1, 44–50.

<sup>57</sup> COM(2010) 549 final.

<sup>58</sup> Explanatory Memorandum to COM(2011) 594 final.

<sup>59</sup> Staff of the International Monetary Fund (2010), p. 25.

<sup>60</sup> Staff of the International Monetary Fund (2010).



environment. Through the incorporation of provisions within FSC that increase the tax burden on banks in relation to risk, FSC can target specific actors operating in the financial sector. Consideration of risk would include a review of the size of the institution, interconnectedness between institutions and the substitutability of each.<sup>61</sup> Focusing on these issues are important given the events that took place during the early period of the financial crisis where we saw the failure of a number of major financial institutions including Fannie Mae, Freddie Mac and the Lehman Brothers. The collapse of these important financial institutions resonated throughout the financial world as regulators allowed banks to become too large, and to increase their interdependence to excessive levels.

FSC specifically aims to ensure that the sector makes a contribution to resolution fund and reduce systematic risk.<sup>62</sup> In line with this objective, FSC may accordingly be introduced either in a permanent or temporary manner. The impact of FSC will ultimately depend on the size of the tax base, but could potentially amount to 2% of GDP in some countries.<sup>63</sup>

The Commission has chosen not to make VAT on financial services offered by the financial sector mandatory and, as a result, most Member States opt to exempt<sup>64</sup> most, or all, services offered by the sector. This provides financial institutions with a distinct advantage, including lower tax costs and cost savings with respect to administration and compliance. The exemption status of many financial institutions has led to claims that the sector, as a whole, is undertaxed.<sup>65,66,67,68,69,70</sup> The potential for revenue generation is substantial, even if deductions for VAT on inputs are taken into consideration.<sup>71</sup> Some argue that it would be technically difficult to charge VAT on financial services.<sup>72</sup> Technical issues, however, could be overcome.<sup>73</sup> The framework that already exists within the EU for administration and

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<sup>61</sup> Staff of the International Monetary Fund (2010).

<sup>62</sup> Staff of the International Monetary Fund (2010).

<sup>63</sup> Staff of the International Monetary Fund (2010).

<sup>64</sup> Article 135(1) of Council Directive 2006/112/EC on the common system of VAT.

<sup>65</sup> COM(2011) 594 final.

<sup>66</sup> De la Feria, R., & R. Krever (2013): 'Ending VAT Exemptions: Towards A Post-Modern VAT'. Oxford University Centre for Business Taxation, Said Business School, Oxford, WP12/28.

<sup>67</sup> Hernández González-Barreda, P.A. (2013): 'On the European Way to a Financial Transaction Tax under Enhanced Cooperation: Multi-speed Europe or Shortcut?'. *Intertax* 41/4, 208-229.

<sup>68</sup> Kavelaars, P. (2012).

<sup>69</sup> Henkow, O. (2012).

<sup>70</sup> Hein, R. (2012): 'The Financial Transaction Tax: Where's Robin Hood'. *IBFD, Derivatives and Financial Instruments*, 14/1, 122-24.

<sup>71</sup> Contrary to claims of under taxation, the lack of input deductions could lead to over taxation and a high tax burden for the sector. See Commission Staff Working Paper Impact Assessment Accompanying the document Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC Vol. 6. Brussels, 28.9.2011. SEC(2011) 1102 final.

<sup>72</sup> Hernández González-Barreda, P.A. (2013).

<sup>73</sup> SEC(2011) 1102 final, Vol. 1.

compliance of VAT is an advantage that this tax instrument has over FAT, FSC and FTT. Furthermore, the application of VAT principles which exempts most transactions undertaken with persons in third countries, would also help to overcome the criticism levied against FTTs' extraterritorial effect (see Section 1.5.). Even though the potential for revenue generation under VAT might be quite substantial, full adoption of VAT is not, however, always convincing. VAT may not be able to address the speculative nature of the transactions, which discourages changes to the present treatment of the financial sector. It is this lack of focus which makes VAT not the preferred means to tax the financial sector, and places FTT in a more preferential light. There are, however, some aspects that could inspire changes to the Proposal and provide a support framework for implementation that should not be overlooked. These issues are discussed further in Section 3.

In the alternatives discussed above, the main point of each tax instrument is to ensure that the financial sector makes a contribution towards tax revenues in a way which discourages distortive activities and provides revenue sources for authorities. Unfortunately the incidence is always likely to be passed on to end consumer in one way or another (see Section 1.4.). Empirical research on tax incidence to identify which alternative would give rise to the least incidence of shifting is not available. The tax base for each tax instrument may help shed light on this issue,<sup>74</sup> but must still be considered within the perspective of elasticities of demand and supply. Ultimately the tax instrument selected must be fit for purpose.<sup>75</sup> Within the objectives outlined by the Commission itself in 2010, focusing on reducing volatility, increasing revenue generation and fairness,<sup>76</sup> the Commission has chosen to pursue FTT.

### **1.3. The European Unions' Proposal for Financial Transaction Tax**

Article 113 and 115 of the Treaty on the Functioning of the European Union (TFEU)<sup>77</sup> provides the legal basis for the introduction of FTT through enhanced cooperation procedure amongst participating Member States. The Proposal is based on the theories of John Keynes<sup>78</sup>

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<sup>74</sup> FTT is cumulative and causes a cascading effect. VAT is charged on net values but is ultimately paid by the end user. FSC and FAT are paid by banks. Banks may shift costs to end customers by charging higher fees for services.

<sup>75</sup> Shaviro, D. N. (2012).

<sup>76</sup> The Commission noted that the choice of a tax instrument had to fulfil three main criteria. Firstly, had to enhance the efficiency and stability of financial markets and reducing their volatility. Secondly, it had to contribute to fiscal consolidation and auxiliary resources as well as economic efficiency. Thirdly, as most financial services are VAT exempt, any instrument selected would need to make a fairer and more substantial contribution to government finances. See COM(2010) 549 final.

<sup>77</sup> Treaty on European Union and the Treaty on the Functioning of the European Union OJ C 326, 26.10.2012 2012/C 326/01.

<sup>78</sup> Keynes, J. (1936): 'The General Theory of Employment, Interest, and Money'. Harcourt Brace and Company.

and Nobel Prize laureate James Tobin.<sup>79</sup> Both suggested that transaction taxes could be used to discourage harmful trading with Keynes emphasising the need for markets to refocus on fundamental values while Tobin emphasised the need for transaction taxes to remove the distortive effect of volatility. By throwing ‘sand in the wheels’<sup>80</sup> of market trading, a proportionate tax on gross values would discourage excessive trading and reduce market volatility. By taxing each transaction, the Proposal identifies with the theoretical objectives of Keynes and Tobin by discouraging transactions that do not enhance market efficiency.

The Commission’s Proposal, COM(2013) 71 final, is broad in scope and covers ‘all actors, instruments and markets’.<sup>81</sup> Financial institutions are subject to FTT if they are established in a participating Member State<sup>82</sup> and are considered established if they have authorisation, a registered seat, a permanent address or have a branch in a participating Member State.<sup>83</sup> Financial institutions located in third countries are also subject to FTT through the principle of deemed establishment<sup>84</sup> (see Section 1.5.).

Secondly, all instruments are subject to FTT which is charged on gross values, before netting and settlement.<sup>85</sup> Transactions subject to FTT include all purchases and sales, transfers between groups, conclusions of derivative contracts and exchange and repurchase agreements.<sup>86</sup> The rate of tax is 0.01% on derivative contracts and 0.1% on other financial instruments.<sup>87</sup> The Proposal does not solely focus on speculative trading,<sup>88</sup> which contrasts to some extent with the objectives of the Proposal (see Section 1.1.) as all trades, whether distortive or otherwise, will be subject to FTT. The rates established within the Proposal are minimum rates; as a result, Member States are free to set higher tax rates of tax.<sup>89</sup> FTT is

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<sup>79</sup> Tobin, J. (1974): ‘The New Economics One Decade Older’. The Eliot Janeway lectures on historical economics in honour of Joseph Schumpeter, 1972. Princeton, N.J

<sup>80</sup> Although Tobin used the reference with respect to money markets, it is equally applicable to transactions undertaken within the wider context of financial markets, which were the focus of Keynes proposal for a general financial transaction tax. See Tobin, J. (1978): ‘A Proposal for International Monetary Reform’. *Eastern Economic Journal* 4, 153–159.

<sup>81</sup> Commission Staff Working Document Impact Assessment Accompanying the document Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax Analysis of policy options and impacts Brussels, 14.2.2013, SWD(2013) 28 final.

<sup>82</sup> Article 4(1), COM (2013) 71 final.

<sup>83</sup> Article 4(1)(a) to (e), COM(2013) 71 final.

<sup>84</sup> Article 4(1)(f) and (g), COM(2013) 71 final.

<sup>85</sup> Article 9, COM(2013) 71 final.

<sup>86</sup> Article 2(2), COM (2013) 71 final. The definition of taxable financial instruments makes reference to section C of Annex 1 of the MIFID Directive 2004/39/EC and includes structured products. See Article 2(3), COM(2013) 71 final.

<sup>87</sup> Article 9, COM(2013) 71 final.

<sup>88</sup> Other countries such as France and Italy make a distinction based on the type of trading undertaken which may be linked to speculative activities. Italy for instance taxes high frequency trades at a 0.02% separate tax rate while France taxes high frequency trades at 0.01%. Italy also taxes derivatives at separate rates.

<sup>89</sup> They are unlikely to do so to ensure that tax competition between participating Member States does not arise.

charged on both legs of a transaction, which doubles the effective rates of tax outlined within the Proposal. In the case of transactions other than derivatives, the taxable amount of FTT is based on consideration paid,<sup>90</sup> whilst transactions carried out between entities in a group are subject to market price considerations.<sup>91</sup> The taxable amount for derivatives is the notional amount referred to in the derivative contracts.<sup>92</sup> In all cases, tax is charged at the moment the transaction occurs.<sup>93</sup>

Financial instruments issued within a participating Member State are subject to FTT, regardless of the place where the transaction is undertaken.<sup>94</sup> The combination of residence and issuance principles gives FTT an extraterritorial effect, which means that there are limited circumstances where FTT would not apply (see Section 1.6.). Economic substance provisions are considered within the Proposal,<sup>95</sup> which removes tax liability if no economic link to a participating Member State is found. But guidance on this issue is limited even if it remains a crucial provision to moderate the excessive territorial effects of FTT.<sup>96</sup>

Thirdly, all markets are subject to FTT. This is due not only to the combination of factors outlined above, but also to the limited exemptions found within the Proposal. Exempt transactions include primary market transactions, transactions with central banks, the European Financial Stability Facility and the European Stability Mechanism.<sup>97</sup> Also excluded are every day transactions such as ‘the conclusion of insurance contracts, mortgage lending, consumer credits, enterprise loans and payment services currency transactions on spot markets’.<sup>98</sup> Exemptions outlined within the Proposal, however, do not take into consideration the different legal characteristics of financial products, which may be structured differently in each Member State.

The Proposal complies in full with the Capital Duty Directive.<sup>99</sup> Furthermore, it does not hinder the rights of authorities within the EU from raising capital. Restructuring of operations are also exempt,<sup>100</sup> but surprisingly, the cancellation or rectification of financial

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<sup>90</sup> Article 6(1), COM(2013) 71 final.

<sup>91</sup> Article 6(2), COM(2013) 71 final.

<sup>92</sup> Article 7, COM(2013) 71 final.

<sup>93</sup> Article 5(1), COM(2013) 71 final.

<sup>94</sup> Article 4(1)(g) and 2(c), COM(2013) 71 final.

<sup>95</sup> Article 4(3), COM(2013) 71 final.

<sup>96</sup> Englisch, J., J. Vella, & A. Yevgenyeva (2013): ‘The Financial Transaction Tax Proposal Under The Enhanced Cooperation Procedure: Legal and Practical Considerations’. *British Tax Review*, 2, 111-260.

<sup>97</sup> Article 3, COM (2013) 71 final.

<sup>98</sup> Explanatory Memorandum to COM(2013) 71 final, p. 9.

<sup>99</sup> Council Directive 2008/7/EC of 12, February 2008 concerning indirect taxes on the raising of capital (2008) OJ L46/11.

<sup>100</sup> Article 3(4)(g), COM (2013) 71 final.

instruments are still subject to FTT.<sup>101</sup> The latter is decisively at odds with the design of tax instruments in general. Such provisions mean that the Proposal makes a number of assumptions on transactions carried out in the financial sector. It assumes to some degree that all trades are pursued to completion, and if they are not, this reflects an intention to avoid tax payment, which may not be the case. Only errors are excluded from being subject to FTT.<sup>102</sup> The wide net of the Proposal in this respect does act as an important tool against speculative trading by discouraging spoofing,<sup>103</sup> which causes volatility in market.

Implementation and administration of the Proposal rests with individual Member States.<sup>104</sup> Little guidance however is provided in this regard which may cause implementation problems. The Proposal does, however, highlight that payment must be made within three working days, or immediately in the case of transactions undertaken electronically.<sup>105</sup> It further adds that participating Member States should adopt measures that prevent fraud and evasion within their jurisdiction.<sup>106</sup> The Proposal also includes general anti-avoidance provisions,<sup>107</sup> which are similar to provisions outlined in the Commission Recommendation on aggressive tax planning.<sup>108</sup> This broad general guidance on how FTT is to be administered by Member States may give rise to implementation problems. Additionally, national measures may conflict where cross border transactions are subject to different requirements and no common framework for resolution is found.

Another aspect incorporated within the Proposal, which is not generally found in the other tax instruments, is the concept of joint and several liability.<sup>109</sup> The inclusion of this provisions in the Proposal means that if any party to the transaction does not pay the amount

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<sup>101</sup> Article 5(2), COM (2013) 71 final.

<sup>102</sup> Article 5(2), COM(2013) 71 final.

<sup>103</sup> The US Commodity Futures Trading Commission has opened a civil enforcement action in the US against Navinder Singh Sarao and his trading company Nav Sarao Futures Limited plc. He is accused of unlawfully manipulating, attempting to manipulate and spoofing the markets. Mr Sarao is accused of setting up deals in the E-mini S&P 500 stock market index future contracts which were not carried out but which created artificial volatility. This included placing orders which were cancelled and for which he had no intention to carry out. From his activities he gained substantially by taking advantage of market conditions that he himself helped to create. The US Commodity Futures Trading Commission has linked the trades undertaken by Mr Sarao to the market crash of May 2010, often referred to as the Flash Crash Day. Had the transactions been subject to a financial transaction tax such as FTT, the non-execution of these transactions by Sarao would have still been taxable and would have invoked high costs due both to the significant values of the trade and aggressive nature of manipulative trading that was created by Mr Sarao actions. See US Commodity Futures Trading Commission, 'CFTC Charges UK Resident Navinder Singh Sarao and His Company Nav Sarao Futures Limited PLC with Price Manipulation and Spoofing,' Release PR7156-15, April 21, 2015.

<sup>104</sup> Article 11(1), COM(2013) 71 final.

<sup>105</sup> Article 11(5), COM(2013) 71 final.

<sup>106</sup> Article 12, COM(2013) 71 final.

<sup>107</sup> Article 13, COM(2013) 71 final.

<sup>108</sup> Commission Recommendation on aggressive tax planning (2012) OJL 338 L 338/41 C(2012) 8806 final.

<sup>109</sup> Article 10(3), COM(2013) 71 final.

of FTT due on their leg of a transaction, the other party shall be liable on his behalf. This could potentially expose companies located in participating Member States to uncertainty and higher costs as authorities can more easily access payment on domestic taxpayers, than on those resident abroad. Within all EU Member States, enforcement is supported by a number of existing agreements<sup>110</sup> but such agreements are unlikely to be in place with all third countries. Joint and several liability may be more burdensome where enforcement agreements with third countries are lacking.<sup>111</sup> It is, however, reasonable to assume that financial institutions are likely to consider the reputation of counterparties<sup>112</sup> before undertaking transactions in such situations, and consider this within their risk profiling before entering into any transaction.

#### **1.4. Incidence of Transaction Taxes**

A primary objective of the Proposal is to ensure that the financial sector makes a ‘fair’ and ‘substantial’ contribution towards covering the costs of the financial crisis.<sup>113</sup> Liability for FTT should fall on financial institutions<sup>114</sup> but there is growing support that the incidence of FTT may in fact be shifted onto end consumers of financial services.<sup>115,116,117</sup> Users of financial instruments may find that they are charged higher transaction costs or higher administrative fees as financial institutions pass on their additional tax burden (from FTT) to them.

The issue of tax incidence depends on a number of factors. It will depend on elasticity of demand and supply for financial instruments, as well as the reaction of competitors in other

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<sup>110</sup> Enforcement is facilitated by the following Directives: Directive 2011/16/EU of the Council of 15 February on administrative cooperation in the field of taxation and Directive 2010/24/EC of the Council of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures. With OECD countries the OECD - Council of Europe Multilateral Convention on Mutual Administrative Assistance in Tax Matters is applicable. Tax treaties between Member States and third countries may not necessarily incorporate provisions which have the same effect.

<sup>111</sup> The United Kingdom used the so-called season ticket system to overcome some of the problem that could arise in attempting to ensure that foreign traders pay all domestic taxes. This, however, was found to be contrary to EU law and was later abolished. See *HSBC Holdings plc, Vidacos Nominees Ltd v. The Commissioners of Her Majesty’s Revenue & Customs*, Case C-569/07.

<sup>112</sup> Commission Staff Working Document of 14 February 2013 Impact Assessment, Accompanying the document Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, Analysis of policy options and impacts, SWD(2013) 28 final.

<sup>113</sup> The objectives of the Proposal include obtaining a fair and substantial contribution for the costs of the crisis through the generation of sufficient tax revenues, while at the same time seeking to disincentivizing risky activities in the form of speculative trading by financial institutions operating in or through Europe.

<sup>114</sup> Article 10(1), COM(2013) 71 final.

<sup>115</sup> Staff of the International Monetary Fund (2010).

<sup>116</sup> Oxera Consulting Ltd (2011): ‘What Would Be the Economic Impact of the Proposed Financial Transaction Tax on the EU? Review of the European Commission’s Economic Impact Assessment’. Prepared for Association for financial markets in Europe, ASSOSIM (Italian Association of financial intermediaries), and Nordic Securities Association (NSA), Oxera, Oxford, England.

<sup>117</sup> Davis J, B. Smith, M. Wagner, & R. O’Kelly (2013): ‘The impact of the EU-11 financial transaction tax on end-users’. Oliver Wyman, Marsh & McLennan Companies.

markets.<sup>118</sup> It will also depend on the availability of domestic substitutes and investors attitudes towards investing abroad. Trading costs to enter foreign markets, particularly fixed costs, could sustain home bias.<sup>119</sup> The Mirrlees Report<sup>120</sup> on tax design noted that the incidence of taxation will in due course always fall on the owners (shareholders), customers or employees of any company subject to taxation. This may prove positive if we consider that wealthy individuals may hold a larger proportion of financial instruments than individuals in low and middle income groups.<sup>121,122,123</sup> The taxation of financial instruments could in this case be considered as progressive in nature if, in fact, the ownership and thus incidence of the tax did fall mainly on wealthy individuals.<sup>124,125</sup> Others, however, query whether taxes on financial transactions could have an opposite effect. If taxes cause a barrier for individuals to enter financial markets, they not only lose the benefits of diversification but may also expose themselves to higher risks associated with the holding of cash. This would prove regressive in nature for individuals and thus have an opposite effect to what would be considered as a fair outcome of FTT.<sup>126</sup>

### **1.5. The (Extra)Territorial Effect of Financial Transaction Tax**

The Proposal incorporates a number of important provisions to ensure that FTT, when implemented, is paid by all parties to a financial transaction. This is achieved through the extraterritorial effect of FTT that is derived from the application of both the principles of deemed establishment and issuance (see Section 1.3.). Briefly, the extraterritorial effect of FTT arises in the following manner. Firstly, a party to a financial transaction that is located outside a participating Member States is subject to FTT if the financial instrument that it is trading in was issued in a participating Member State (issuance principle).<sup>127</sup> Secondly, financial institutions located in a third country are also subject to FTTs' extraterritorial effect when they undertake any transaction with a financial institution established within a participating Member

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<sup>118</sup> Staff of the International Monetary Fund (2010).

<sup>119</sup> Amadia, A. A., & R.P. Bergin (2008): 'Understanding International Portfolio Diversification and Turnover rates,' *International Financial Markets, Institutions and Money*, 18, 191-206.

<sup>120</sup> Mirrlees J., S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles & J. Poterba (2011): 'Tax by Design'. Oxford University Press.

<sup>121</sup> Baker D. (2009): 'The Need to Tax the Wealthy'. *The Economist*, April 14. Available at: <http://www.cepr.net/index.php/op-eds-&-columns/op-eds-&-columns/the-need-to-tax-the-wealthy/>.

<sup>122</sup> Claessens, S., M. Keen, & C. Pazarbasioglu, eds. (2010).

<sup>123</sup> Matheson, T. (2011): 'Taxing Financial Transactions: Issues and Evidence'. IMF WP/11/54.

<sup>124</sup> SEC(2011) 1102 final.

<sup>125</sup> Kapoor, S. (2010): 'Financial Transaction Taxes: Tools for Progressive Taxation and Improving Market Behaviour,' *Re-Define Policy Brief*, London: Re-Define.

<sup>126</sup> Arbeláez, M. A., L. E. Burman, & S. Zuluaga (2005): 'The bank debit tax in Colombia', in Richard M. Bird, J. M. Poterba, & J. Slemrod (eds.), *Fiscal reform in Colombia: Problems and Prospects*, MIT Press.

<sup>127</sup> Article 4(1)(g) COM(2013) 71 final.

State. By this act, they are deemed to be established in the jurisdiction of that counterparty.<sup>128</sup> This is known as the counterparty principle.<sup>129</sup> The counterparty principle and issuance principle together ensure that FTT is always paid on both legs of a transaction regardless of the location of the trading parties. It, however, makes us question if this may conflict with the principles of international public law.

International public law provides that jurisdiction to tax is based on the principles of residence and/or source based rules. These principles of taxation are based on a link or nexus (residence or source) existing between the taxpayer and the taxing jurisdiction. Conflicts arise with the application of FTT as counterparties to a financial transaction, who are not located in a participating Member State, are still subject to FTT. Such companies would in most circumstances be generally considered as only trading *with* the jurisdiction and not trading *in* the jurisdiction, and hence would not generally be subject to tax.

The Commission, in 2013, sought to clarify this issue by stating that a financial institution that trades with a counterparty located within a participating Member State is ‘contributing to the achievement of a legally relevant result within that jurisdiction’.<sup>130</sup> In this way, a sufficient nexus with the jurisdiction is created, and therefore, according to the Commission, no conflict arises with international public law.<sup>131</sup> Furthermore, the Commission added that the rights of non-participating Member States to remain outside the enhanced cooperation zone are not compromised by the extraterritorial effect of FTT. Any double taxation that may arise is purely international double taxation. The latter, it argued, arises in many other cases too, and therefore, if it arises within the context of FTT, this is simply a reflection of what happens elsewhere. This therefore cannot be used as an indication of discrimination against any party as each Member State is free to continue with their own transaction taxes. According to the Commission, Article 327 is therefore safeguarded. Moreover, it adds that any cross border issues that arise cannot be considered as a hindrance to free movement of capital otherwise every tax on cross border trade would be considered as an obstacle. The apparent incompatibility of FTT with international or European law was also

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<sup>128</sup> Article 4(1)(f) COM(2013) 71 final.

<sup>129</sup> Under the counterparty principle, the counterparty located outside the enhanced cooperation zone is deemed to be established in the participating Member State that is linked to the transaction and liable for payment of FTT. See Article 4(1)(f) COM(2013) 71 final.

<sup>130</sup> Commission, ‘Legality of the “counter-party principle” laid down in Article 4(1)(f) of the Commission Proposal for a Council Directive implementing enhanced cooperation in the area of FTT– COM(2013) 71 final of 14 February 2013.’ European Commission, p. 1.

<sup>131</sup> Legality of the ‘counter-party principle’ laid down in Article 4(1)(f) of the Commission Proposal for a Council Directive implementing enhanced cooperation in the area of FTT– COM(2013) 71 final of 14 February 2013.



addressed by the EU Commission's Director for indirect taxation. In 2014, Mr Bergmann<sup>132</sup> stated that 'sufficient connection' with participating Member States arises where either the 'the seller's residence, the buyer's residence, the place of the transaction and the place of issue of the product traded' arises within a participatory Member State.<sup>133</sup> He rejects that FTT could conflict with international law on allocation of taxing rights, referring to the fact that if a general rule did exist and jurisdictions applied this around the globe, then the issue of double taxation would never arise.

This contrasts sharply with the opinion expressed by the Legal Services of the European Commission. The latter expressed its concern that FTT does in fact create conflict. In particular, the Legal Services highlighted that the extraterritorial effect of FTT does not tally with the position of the Commission in regards to the Helms-Burton legislation,<sup>134</sup> nor could the exceptions in Wood Pulp<sup>135</sup> be applied. It further notes that the extraterritoriality effect of FTT cannot be justified on the basis of revenue generation, contributions to the financial crisis, the need to discourage risk taking, or the need to have in place measures to avoid evasion or fraud, or potential relocation to non-participating countries.<sup>136</sup> Furthermore, the difference in treatment between participating and non-participating Member States, which gives rise to higher opportunities for enforcement of joint and several liability within participating Member States, could impact free movement of capital. It holds the opinion that FTT could also impede the right of non-participating Member States to remain outside the enhanced cooperation zone, as financial institutions within their Member State will still be required to pay FTT. The Legal

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<sup>132</sup> Bergmann, M. (2014): 'Can we go further than the current national rules? Legal aspects'. Speech, 23, January. Available at: [http://ec.europa.eu/taxation\\_customs/taxation/other\\_taxes/financial\\_sector/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.htm).

<sup>133</sup> Bergmann, M. (2014).

<sup>134</sup> See Cuban Liberty and Democratic Solidarity (LIBERTAD) Act of 1996 known as the Helms–Burton Act. The Act outlined an extension of the territorial application of embargos enacted by the United States against Cuba. The Act penalised any foreign company trading with Cuba, including companies located in the European Union. The European Union condemned the Helms-Burton legislation as infringing on international law and sovereignty and issued Council Regulation (EC) No 2271/96 of 22 November 1996 protecting against the effects of the extra-territorial application of legislation adopted by a third country, and actions based thereon or resulting therefrom. The Regulation provides protection against and counteracts the effects of the extra-territorial application of measure taken by the USA in the Helms–Burton Act. The European Union will protect any natural or legal person who may suffer any threat to its economic and/or financial interests.

<sup>135</sup> Judgment of the ECJ of 31 March 1993 in joined cases C-89/85 and others, ECR 1993, Page I-01307. This case outlines the communities' jurisdiction in competition law. Wood pulp producers from Canada, Finland, Sweden and the USA were found to have created a cartel outside the European Union but which affect buyers in the European Union. The European Union brought about an action against the producers on the grounds that it infringed competition rules under Article 85 of the Treaty (now Article 101 of the TFEU). The producers argued that the communities' jurisdiction could not extend to them and that the extraterritorial effect was contrary to the objectives of the article but the ECJ disagreed and upheld the position of the Commission.

<sup>136</sup> Council of the European Union, Opinion of the Legal Service of 6 September 2013, Subject: Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax (FTT), Legality of the counterparty-based deemed establishment of financial institutions (Article 4(1), point (f) of the Proposal), 2013/0045 (CNS).

Services concludes that FTT not only exceeds Member States' 'jurisdiction for taxation under the norms of international customary law', but furthermore, 'infringes the tax competences' of non-participating Member States under Article 327 TFEU and is also 'discriminatory' and 'distortionary' to the detriment of non-participating Member States.<sup>137</sup>

The need for FTT to have an extraterritorial effect must be balanced with the need to reduce the likelihood of tax avoidance. Like trading parties, they will consider the cost of doing business after the introduction of a new tax, and will look for ways how best to reduce their costs. Foreign direct investment to the participating Member States will be affected if traders opt to stay away.

Although subject to much criticism, the extraterritorial effect of FTT is also found in other taxes. A case in point is controlled foreign corporation (CFC) legislation. CFC legislation extends a country's taxing right where no distributions have been made by a foreign subsidiary to a resident shareholder. The extension of a country's taxing right to tax profits which have as yet not been distributed, is a significant anti-avoidance provision and is applied in a number of Member States, including the UK which is opposed to FTT.<sup>138</sup> The UK has unsuccessfully challenged the Commission's right for FTT to incorporate an extraterritorial effect.<sup>139</sup> Stamp duty legislation in the UK incorporates an extraterritorial effect through the application of the issuance principle.

The EU's proposal for a Common Consolidated Corporate Tax Base (CCCTB) also incorporates extraterritorial elements. Due to the proposed method of apportionment of income under the CCCTB system, income allocation between companies in a group is determined on the basis of a formulary apportionment approach. If CCCTB were to be adopted, Member States would be granted a right to tax income allocated to companies located within their jurisdiction, even though that income may not necessarily be linked to that State. Although this legislation is still to be enacted, one legislation which is in force today and which incorporates an extraterritorial effect is the US Foreign Account Tax Compliance Act (FATCA). FACTA specifically focuses on the financial services sector. Through the exchange of information agreements<sup>140</sup> signed under FACTA, the United States is provided with information regarding

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<sup>137</sup> Council of the European Union, Opinion of the Legal Service of 6 September 2013, Subject: Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax (FTT), Legality of the counterparty-based deemed establishment of financial institutions (Article 4(1), point (f) of the Proposal), 2013/0045 (CNS), p. 14.

<sup>138</sup> Although a number of exemptions apply.

<sup>139</sup> See *United Kingdom of Great Britain and Northern Ireland v. Council of the European Union*, Case C- 209/13.

<sup>140</sup> To date, the United States has managed to sign agreements with seventeen countries; Bermuda, the Cayman Islands, Costa Rica, Denmark, France, Germany, Guernsey Ireland, Isle of Man, Japan, Jersey, Malta, Mexico, Norway, the Netherlands, Spain, Switzerland and the United Kingdom. Such coordination in terms of automatic

investments made by its residents with non-US financial institutions. Although similar to exchange of information agreements found under tax treaty provisions, it places a direct burden on financial institutions to provide information automatically. These financial institutions are subject to penalties if information is not provided. While no financial reimbursement for compliance costs incurred by financial institutions is provided for under FACTA, authorities may marginally benefit from reciprocity in information exchange provisions incorporated within agreements signed.

This paper contributes to existing literature in a number of ways. Firstly, it highlights how FTT could impact companies operating within participating Member States. Secondly, the paper outlines key points that need to be considered to revamp the Proposal to reduce the distortive effect within the enhanced cooperation zone for FTT and to encourage adoption by non-participating Member States. This paper is outlined as follows. Section 2 reviews the Proposal under three key thematic areas. Section 3 discusses how the Proposal could be revamped. Section 4 concludes this paper.

## **2. Impact of Financial Transaction Taxes**

### **2.1. Capital**

#### **2.1.1. Transaction Cost and Cost of Capital Implications**

Transaction costs typically include brokerage fees, administrative fees, commissions and transaction taxes. The introduction of FTT increases the cost of capital<sup>141,142,143,144</sup> as financial instruments are subject to higher transaction costs. The significance of this

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exchange of information would also be welcomed at the European level in order to reduce tax evasion and fraud. The Proposal for a Council Directive amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation (COM(2013) 348 final) seeks to achieve just that. Through this initiative, Member States would exchange information automatically, thereby extending the scope of existing exchange of information provisions to include dividends, capital gains, other financial income and account balances. Currently, the Savings Directive does fill a void in existing legislation regarding exchange of information by requiring Member States to levy a withholding tax where information regarding the recipient of interest income has not been submitted to the state of residence of the investment holder.

<sup>141</sup> Summers, H.L., & V.P. Summers (1989): 'When Financial Markets Work Too Well: A Cautious Case For a Securities Transactions Tax'. *Journal of Financial Services Research*, 3, 261-286.

<sup>142</sup> Pomeranets, A. (2012).

<sup>143</sup> Brondolo, J. (2011): 'Taxing Financial Transactions: An Assessment of Administrative Feasibility'. IMF.

<sup>144</sup> Matheson, T. (2011).

issue<sup>145,146,147</sup> is heightened by the important role that an efficient capital market plays within an economy, and how FTT could affect financial markets within participating Member States. Indirectly, the extraterritorial effect of FTT will also affect financial markets in non-participating Member States if financial institutions continue to trade with counterparties located within the enhanced cooperation zone. The EU is, after all, home to some of the largest financial centres in the world, including the stock markets of London and Frankfurt.

As transaction costs increase, rational investors will seek compensatory returns<sup>148,149</sup> if the cost of debt (risk free rate plus credit risk rate x (1 – rate of tax)) or equity (risk free rate of return + premium) increase.<sup>150</sup> Investors may either purchase shares at lower prices or seek higher dividends to compensate for the higher cost of trading. Some investors may simply decide to refrain from trading and avoid the extra cost,<sup>151</sup> but if investors do move away from financial markets to avoid FTT, they forgo both the benefits of market knowledge<sup>152</sup> and services (liquidity, risk assumption, price stability and matching buyers and sellers).<sup>153</sup> Furthermore, FTT could lead to portfolio distortions if decisions are overly influenced by taxation.<sup>154</sup>

Ultimately, it is the number of trades which determines the extent to which FTT will affect the cost of capital.<sup>155</sup> Long-term holdings would help to ‘dampen’ higher costs,<sup>156</sup> but the impetus for long-term holdings is questionable. As noted above, investors may simply seek compensatory returns rather than focus on scaling down turnover.<sup>157</sup> Furthermore, the issues

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<sup>145</sup> Hawkins, M., & J. McCrae (2002): ‘Stamp Duty on Share Transactions: Is There A Case for Change?’. Institute for Fiscal Studies.

<sup>146</sup> Buckley, R., & G. North (2011).

<sup>147</sup> Matheson, T. (2011).

<sup>148</sup> Schwert, G.W., & P.J. Seguin (1993): ‘Securities Transaction Taxes: An Overview of Costs, Benefits and Unresolved Questions’. *Financial Analysts Journal*, 49/5, 27-35.

<sup>149</sup> Oxera Consulting Ltd (2011).

<sup>150</sup> Assuming that international rates of return are given by  $R^*$  where return in a country is  $R = \frac{(P_{t+1}-P_t)+Dt}{P_t}$  and  $P_t$  is the value of the principle and  $Dt$  is the dividend received in period  $t$ , if in one jurisdiction transaction costs have to be incurred, in equilibrium, the rate of return in this country must increase.

<sup>151</sup> Campbell, J.Y., & K.A. Froot (1994): ‘International Experiences with Securities Transaction Taxes’. *The Internationalization of Equity Markets*, University of Chicago Press, 277-308.

<sup>152</sup> Kavelaars, P. (2012).

<sup>153</sup> Habermeier, K., & A.A. Kirilenko (2003): ‘Securities Transaction Taxes and Financial Markets’. *IMF Staff Papers* 50, 165-180.

<sup>154</sup> The negative impact on portfolio diversification exposes investors to greater risk. Blackrock (AIMA, 2012) retrospective analysis of fund data shows that the annual cost of FTT would range from 0.01% to 2.57% in higher costs, depending turnover and investment. The results obtained by Oxera (Oxera Consulting Ltd (2011) p. iv.) were even higher (2.7% to 5.5%) when taking into consideration the cascading (see AIMA (2012)) for an illustrated example of the effect of cascading). These results were also supported the European Fund and Asset Management Committee in 2012 who also agreed on the likely outcome on liquidity and volatility.

<sup>155</sup> Matheson, T. (2011).

<sup>156</sup> Matheson, T. (2011).

<sup>157</sup> Matheson, T. (2011).

discussed here are not limited to the private sector. Governments too utilise financial markets to access finance.<sup>158</sup> The cost of the financial crisis has already strained government revenues, but FTT could also increase the borrowing costs of authorities as they access financial markets to borrow from the private sector.

### **2.1.2. Debt vs. Equity Financing**

A tax on financial instruments would affect both debt and equity. According to the pecking order theory of finance,<sup>159</sup> the least costly source of finance are retained earnings,<sup>160</sup> followed by debt and then equity, in that order. This order may become distorted by the preferential tax treatment of debt.<sup>161</sup> Even without the pecking order theory, if investors or firms have a particular preference, the tax system should not bias their choice. Within the context of the Proposal, the differential rate of taxation between derivatives and non-derivative products may also give rise to further bias, whilst investors may also favour primary listings and government debt which are also exempt from FTT. The bias that may arise towards government treasury bills and bonds may not always be preferential.<sup>162</sup> Progressive implementation of FTT that has been recently proposed by some Member States, which favours staggering the introduction of FTT on derivative products, would also cause bias.<sup>163</sup> This may arise in any case under the current Proposal if derivatives are used as substitute for non-derivative transactions, which may not necessarily trigger current anti-avoidance provisions.

The effect of FTT on debt and equity financing is also amplified by the size of a company. When seeking to raise finance, larger firms may be affected more by FTT than smaller firms that are generally ‘restricted to the loan market’.<sup>164</sup> Furthermore, FTT also affects working capital requirements of companies subject to FTT, and due consideration needs to be taken in this regard.<sup>165</sup>

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<sup>158</sup> World Bank (2009): ‘Global Development Finance Charting a Global Recovery I: Review, Analysis, and Outlook’. The International Bank for Reconstruction and Development, The World Bank.

<sup>159</sup> Myers, S. C. (1984): ‘The Capital Structure Puzzle’. *The Journal of Finance*, 39/3, 574-592.

<sup>160</sup> Oxera notes that the Commission’s assumption that the burden of FTT could be reduced by financing sourced from retained earnings is unlikely. See Oxera Consulting Ltd (2011).

<sup>161</sup> Hudson, V., & C. Roy-Chowdhury (2010): ‘Tax after the Financial Crisis’. ACCA Position Paper, ACCA.

<sup>162</sup> Oxera Consulting Ltd (2011).

<sup>163</sup> Joint Statement by ministers of Member States participating in enhanced cooperation in the area of financial transaction tax, Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia and Spain. Brussels 6 May 2014.

<sup>164</sup> Matheson, T. (2011), p. 31.

<sup>165</sup> Comotto, R. (2013): ‘Collateral damage: the impact of the Financial Transaction Tax on the European repo market and its consequences for the financial market and the real economy’. International Capital Markets Association European Repo Council.

### 2.1.3. Employment

Pomeranets states that increasing capital costs would negatively affect the ‘flow of profitable projects, [...] real production, expansion, capital investments and even employment’.<sup>166</sup> If the financial sector is negatively affected by FTT, it may have no option but to reduce its workforce. A brain drain of well educated, talented individuals from participating Member States to competitive markets will have long-run repercussions for the financial institutions located in the former Member States. Competitors may significantly benefit from a knowledgeable workforce that has an intimate understanding of domestic markets and legislation. The United Kingdom could, for instance, lose up to 25% of its workforce under the current Proposal,<sup>167</sup> with the rest of Europe also suffering significant job losses if the Proposal were to be introduced.<sup>168</sup> Wage levels may also be affected<sup>169</sup> as financial institutions try to cut expenses to compensate for the higher cost of doing business in an FTT environment.

Some have argued that any downsizing of the workforce could simply help to rebalance the allocation of labour within an economy. Well before the financial crisis even started, there was a view amongst some academics that the financial sector already contained excess labour resources.<sup>170</sup> As employment in the sector grew, productive real activities suffered.<sup>171</sup> Diverting human capital away from the financial markets back towards ‘real’ activities could prove beneficial to the overall economic growth of a country and help to counter balance the negative effects of FTT.

### 2.1.4. Asset Values

Both theory and empirical results shows that transaction taxes reduce after-tax asset values.<sup>172,173,174,175,176</sup> The empirical results (see Table 2) highlight that the effect on asset prices is consistent over time and in different markets. The discounting of future returns results in

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<sup>166</sup> Pomeranets, A. (2012), p. 9.

<sup>167</sup> AIMA Research Note (2012), p.15.

<sup>168</sup> European Commission, Memo on Financial Transaction Tax through Enhanced Cooperation: Questions and Answers, Memo/13/98. Brussels, 14 February 2013.

<sup>169</sup> Rogoff, K. (2011): ‘The Wrong Tax for Europe’. Reuters, 3rd October.

<sup>170</sup> Summers, H. L., & V. P. Summers (1989).

<sup>171</sup> Matheson, T. (2011).

<sup>172</sup> Schwert, G. W., & P. J. Seguin (1993).

<sup>173</sup> Kupiec, P.H. (1996): ‘Noise traders, excess volatility, and a securities transactions tax’. Journal of Financial Services Research 10/2, 115-129.

<sup>174</sup> Habermeier, K., & A. A. Kirilenko (2003).

<sup>175</sup> Matheson, T. (2011).

<sup>176</sup> Brondolo, J. (2011).

lower net present value and hence, lower share prices. This downward pressure on asset values increases the cost of raising capital for a company.<sup>177</sup> The permanent effect will be influenced by the rate of turnover and dividend yield of financial instruments.<sup>178</sup> If the Proposal is adopted, it will have an impact on both.

Table 2– Market Prices and Transaction Taxes

Study	Market	Period	Result
Bond, Hawkins and Klemm (2005) <sup>179</sup>	United Kingdom	1984, 1986, 1990	Reductions in stamp duty had a positive and significant effect on the price of more frequently traded shares compared to less frequently traded shares
Westerholm (2003) <sup>180</sup>	Sweden	1983, 1986, 1991, 1992	Increase in asset prices due to reduction in transaction taxes
Lui (2007) <sup>181</sup>	Japan	1989	Tax reduction led to decline in prices
Hu (1998) <sup>182</sup>	14 changes in transaction taxes in 4 markets: Hong Kong, Japan, Korea and Taiwan	1975 - 1994	Increase in transaction tax reduced stock prices
Umlauf (1993) <sup>183</sup>	Sweden	1980–87	Increase in transaction tax reduced stock prices

## 2.2. Business Strategy

### 2.2.1. Investment Strategy

The growth of financial markets in recent years has outperformed the expansion in economic growth.<sup>184</sup> Accompanying this growth we find a progressive shift away from fundamental values.<sup>185</sup> This shift away from fundamental values of investments is particularly noticeable with respect to the effect that high-frequency trading has had on financial markets.<sup>186</sup>

<sup>177</sup> Culp, C. L. (2010): 'Financial Transaction taxes: Benefits and Costs'. Compass Lexecon.

<sup>178</sup> Hawkins, M., & J. McCrae (2002).

<sup>179</sup> Bond, S., M. Hawkins, & A. Klemm (2005): 'Stamp Duty on Shares and Its Effect on Share Prices'. *FinanzArchiv: Public Finance Analysis* 61/3, 275-297.

<sup>180</sup> Westerholm, P.J. (2003): 'The Impact of Transaction Costs on Turnover, Asset Prices and Volatility: The Cases of Sweden's and Finland's Security Transaction Tax Reductions'. *Liiketaloudellinen Aikakauskirja*, 213-241.

<sup>181</sup> Liu, S. (2007): 'Securities Transaction Tax and Market Efficiency: Evidence from the Japanese Experience'. *Journal of Financial Services Research* 32/3, 161-176.

<sup>182</sup> Hu, S. (1998): 'The Effects of the Stock Exchange Tax on the Stock Market: Experiences from Asian Markets'. *Pacific-Basin Finance Journal*, 6, 3, 347-364.

<sup>183</sup> Umlauf, S.R. (1993): 'Transaction Taxes and the Behavior of the Swedish Stock Market'. *Journal of Financial Economics* 33/2, 227-240.

<sup>184</sup> Darvas, Z., & J. von Weizsäcker (2010): 'Financial Transaction Tax: Small is Beautiful'. Directorate-General for Internal Policies. PE 429.989. IP/A/ECON/NT/2009-08. European Parliament.

<sup>185</sup> Matheson, T. (2011).

<sup>186</sup> Zhang, F. (2010): 'High-Frequency Trading, Stock Volatility, and Price Discovery'. Available at: <http://ssrn.com/abstract=1691679>.

Transaction taxes could help refocus investments,<sup>187</sup> encouraging greater emphasis on the fundamental values of investments and improving market efficiency.<sup>188</sup> Such changes would be in line with the theoretical basis of why transaction taxes were first proposed.<sup>189</sup> As companies reassess their investment strategies within an FTT environment, they may shift their focus to investments having longer periods of time,<sup>190</sup> but it is not clear if this too would encourage a greater focus on fundamental values.<sup>191</sup> If FTT does encourage longer term holdings,<sup>192</sup> this may in turn free up management to look beyond the short term.<sup>193,194</sup> In an FTT environment, frequent short-term trades negatively affect investment returns, and this places pressure on managers to adjust their investment strategies to reduce the cost of FTT.<sup>195</sup> This would affect both real and financial investments, as greater focus is placed on productive uses of resources by managers.<sup>196,197,198</sup> This, however, assumes that long-term planning time horizons are ignored, which may not be the case. A push to alter investment strategies will differ between companies as well as industries. Ultimately, ‘genuine long-term expectation [may be] so difficult’,<sup>199</sup> that it may not be practical for investors.

### **2.2.2. Relocation and Risk**

Given the highly mobile nature of financial transactions, the Proposal seeks to reduce substitution and relocation by being broad in scope.<sup>200</sup> The Commission does, however, accept that relocation will nevertheless take place.<sup>201</sup> Financial institutions that seek to avoid paying

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<sup>187</sup> Summers, H. L., & V. P. Summers (1989).

<sup>188</sup> Pellizzari, P., & F. Westerhoff (2009): ‘Some Effects of Transaction Taxes under Different Microstructures’. *Journal of Economic Behavior & Organization* 72/3, 850-863.

<sup>189</sup> Haq, M., I. Kaul, & I. Grunberg (eds.) (1996): ‘The Tobin Tax: Coping with Financial Volatility’. New York: Oxford University Press.

<sup>190</sup> Stiglitz, J. E. (1989): ‘Using Tax Policy to Curb Speculative Short-Term Trading’. *Journal of Financial Services Research* 3, 101-115.

<sup>191</sup> Dooley, M. P. (1996): ‘The Tobin Tax: Good Theory, Weak Evidence, Questionable Policy’. *The Tobin Tax: Coping with Financial Volatility*, 83-108.

<sup>192</sup> Lui, Y., & D. Mole (1998): ‘The use of fundamental and technical analyses by foreign exchange dealers: Hong Kong evidence’. *Journal of International Money and Finance* 17, 535- 545.

<sup>193</sup> Summers, H.L., & V.P. Summers (1989).

<sup>194</sup> Fricke D. & T. Lux (2013): ‘The Effects of a Financial Transaction Tax in an Artificial Financial Market’. Kiel Working Papers, 1868, Kiel Institute for the World Economy.

<sup>195</sup> Summers, H. L., & V. P. Summers (1989).

<sup>196</sup> Summers, H. L., & V. P. Summers (1989).

<sup>197</sup> Fricke, D., & T. Lux (2013).

<sup>198</sup> Habermeier, K., & A. A. Kirilenko (2003).

<sup>199</sup> Keynes, J. (1936), p. 79.

<sup>200</sup> SEC(2011) 1102 final.

<sup>201</sup> European Commission. Technical Fiche. ‘Relocation, Substitution and Other Market Reactions’. European Commission. Available at: [http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/other\\_taxes/financial\\_sector/fact\\_sheet/relocation.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/fact_sheet/relocation.pdf).



FTT completely would have to abandon all ties with participating Member States – including removing all trading links (residence principle), forgoing all clients located in the enhanced cooperation zone (extraterritorial effect) and ceasing to trade in any financial instruments issued in a participating Member State (issuance principle). Relocation is subject to uncertainty,<sup>202</sup> as well as costs,<sup>203</sup> including the cost of repatriation of funds in terms of periodical dividend payments and / or capital during or at the end of the investment period. Furthermore, relocation could expose companies to systematic risk if investors are attracted to the same markets,<sup>204</sup> due to preferential treatment of certain instruments. Companies, therefore, need to take into consideration both the cost of relocation and the potential returns from foreign investment.

The advantages that FTT may give to non-participating Member States are still unclear. We may, however, see a shift in capital to these jurisdictions<sup>205</sup> as investors favour the domestic European market over foreign jurisdictions,<sup>206</sup> especially if domestic substitutes are available.<sup>207</sup> This helps to keep capital within Europe. Other factors that need to be considered include technical limitations that limit relocation to offshore jurisdictions.<sup>208</sup> A case in point is high frequency trading which requires the support of dedicated IT infrastructure. Moreover, investors do not always look for jurisdictions with the lowest cost.<sup>209</sup> The extent of migration to non-participating Member States or third countries will depend on elasticity of supply and demand for financial instruments. Trading elasticities do vary across market segments,<sup>210</sup> but are still likely to be on the high side.<sup>211</sup> But exactly how markets will react may be difficult to gauge. There is a level of uncertainty even in the estimates put forward by the Commission itself.<sup>212</sup>

FTT may also encourage groups to relocate certain specific activities outside the

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<sup>202</sup> Haq, M., I. Kaul, & I. Grunberg (eds.) (1996).

<sup>203</sup> Cortez, B., & T. Vogel (2011): 'A Financial Transaction Tax for Europe?'. EC Tax Review 1, 16-29.

<sup>204</sup> The introduction of transaction taxes in Sweden resulted in significant shifts to the UK due to preferential tax treatment of instruments. Explanatory Memorandum to COM(2013) 71 final.

<sup>205</sup> Englisch, J., J. Vella, & A. Yevgenyeva (2013).

<sup>206</sup> Cortez, B., & T. Vogel (2011).

<sup>207</sup> Habermeier, K., & A. A. Kirilenko (2003).

<sup>208</sup> Schulmeister, S. (2012): 'A General Financial Transactions Tax: Strong Pros, Weak Cons' in The Financial Transaction Tax – Boon or Bane? *Intereconomics*, 2, 84-89.

<sup>209</sup> Baker, D. (2010): 'Responses to criticisms of taxes on financial speculation'. Center for Economic and Policy Research (CEPR).

<sup>210</sup> Pollin, R., & J. Heintz (2011): 'Transaction Costs, Trading Elasticities and the Revenue Potential of Financial Transaction Taxes for the United States'. Research Brief, Political Economy Research Institute, University of Massachusetts Amherst.

<sup>211</sup> Honohan, P., & S. Yoder (2010): 'Financial Transactions Tax Panacea, Threat, or Damp Squib?'. Policy Research Working Paper 5230.

<sup>212</sup> SEC(2011) 1102 final. Vol. 1.

enhanced zone. This may apply partially to subsidiaries acting as group financier<sup>213</sup> where their presence becomes uneconomical.<sup>214</sup> A judgement call for splitting the treasury function between avoidable and non-avoidable presence within participating Member States might be required. The EU could try to stem the loss of business by adopting ring-fencing provisions. Such provisions would not stray from the objective of the Proposal, as intra-group transactions are generally not speculative in nature.<sup>215</sup>

### **2.2.3. Speculation: A Necessary Evil?**

The Proposal aims to curb speculation and stabilize financial markets. This follows the theories of Keynes<sup>216</sup> and Tobin<sup>217</sup> that transaction taxes improve market stability. Their theories are supported by academics such as Stiglitz<sup>218</sup> and Summers and Summers,<sup>219</sup> who also view transaction taxes as a way to reduce speculative trading. However, empirical research does not always support this position. Although FTT is likely to be effective in reducing automated high-frequency trading and highly leveraged derivatives,<sup>220</sup> its overall effect on speculation is not entirely clear. As shown in Table 3, the impact that transaction taxes have had on market volatility varies, with regional and timing effects providing no indication of why transaction taxes do not always improve market stability.

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<sup>213</sup> Bombeke, G., & E. Bleus (2013): 'Financial Transaction Tax'. *Intertax*, 41/10, 553–556.

<sup>214</sup> The European Association of Corporate Treasurers (2013): 'Comments concerning The Proposal for a Council Directive Implementing enhanced Cooperation in the area of a financial transaction tax Adopted by the European Commission on 14 February 2013'. Available at: <http://www.eact.eu/docs/EACT-FTT-Position-Paper-May13-v2.pdf>.

<sup>215</sup> Many member states apply VAT grouping provisions to avoid charging VAT to the transfer of goods and services between group members in accordance with Article 11 of the VAT Sixth directive. Although VAT as an alternative to FTT has been side-lined, this does not mean that beneficial treatment established by the Sixth Directive itself should be entirely disregarded. The adoption of grouping provisions is recognized as an important cash flow management tool for groups. However, case law permits authorities to restrict the scope of VAT grouping provisions to intra-group transactions undertaken by associated companies located within the same Member State. The principles established by FCE Bank (Judgement of the Court (Second Chamber), 23 March 2006, Case C-210/04, *Ministero dell' Economia e delle Finanze, v. FCE Bank plc.*) would need to be extended to accommodate the highly global scope of FTT, although the argument for group exemptions solely within the Euro zone would require consideration of other factors, such as the application of treaty freedoms applicable to third countries.

<sup>216</sup> Keynes, J. (1936).

<sup>217</sup> Tobin, J. (1974) and Tobin, J. (1978).

<sup>218</sup> Stiglitz, J. E. (1989).

<sup>219</sup> Summers, H. L., & V. P. Summers (1989).

<sup>220</sup> SEC(2011) 1103 final.

Table 3: Inconsistent and Inconclusive Empirical Results – Transaction Taxes and the Impact on Market Volatility

	Market	Period	Result
<b>Positive Effect</b>			
Jones & Seguin (1997) <sup>221</sup>	Commissions on transaction taxes in the United States	1975	Reduction in commission portion of transaction costs led to decrease in volatility and increase in volume
Baltagi, Li & Li (2006) <sup>222</sup>	Impact of stamp tax rate increase in two stock markets in China	1997	Increase in stamp tax caused increase in volatility and volume
Pomeranets & Weaver (2011) <sup>223</sup>	Reviewed nine changes in level of stamp duty in state of New York	1932 - 1981	Increase in stamp duty led to increase in volatility, bid-ask spreads, price impact; volume decreased
Green, Maggioni, Murinde (2000) <sup>224</sup>	Impact of transaction costs of London Stock Exchange	1870 – 1986	Increase in transaction costs generally increase market volatility
Hau (2006) <sup>225</sup>	Review of the impact of transaction costs on selection of stocks on Paris bourse.	1995 – 1998	Analysis of high transaction costs show that transaction taxes can increase volatility.
<b>Inverse affect</b>			
Bond, Hawkins & Klemm (2005) <sup>226</sup>	Effect of reduction of stamp duty in United Kingdom	1984, 1986, 1990	Reduction in stamp duty had a significant and positive effect on price of more frequently traded shares
Liu & Zhu (2009) <sup>227</sup>	Commission deregulation in Tokyo	April 1998 – April 1999	Reduction in commission rates resulted in increase in volatility
Becchetti, Ferrari, & Trenta (2014) <sup>228</sup>	Introduction of French Tobin Tax	90 days trading before and after 1 August 2012	Introduction of FTT reduces volatility

<sup>221</sup> Jones, C. M., & P. J. Seguin (1997): 'Transaction Costs and Price Volatility: Evidence from Commission Deregulation'. The American Economic Review 88/4, 161-176.

<sup>222</sup> Baltagi, B. H., D. Li, & Q. Li (2006): 'Transaction Tax and Stock Market Behavior: Evidence from an Emerging Market'. Empirical Economics 31/2, 393-408.

<sup>223</sup> Pomeranets, A., & D. G. Weaver (2013): 'Securities Transaction Taxes and Market Quality'. Bank of Canada Working Paper 2011-26. Available at: SSRN: <http://ssrn.com/abstract=1980185>.

<sup>224</sup> Green, C., P. Maggioni, & V. Murinde (2000): 'Regulatory Lessons from Emerging Stock Markets from a Century of Evidence on Transaction Costs and Share Price Volatility in the London Stock Exchange'. Journal of Banking and Finance, 24(4), 577-602.

<sup>225</sup> Hau, H. (2006): 'The Role of Transaction Costs for Financial Volatility: Evidence from the Paris Bourse'. Journal of the European Economic Association, 4/4, 862-890.

<sup>226</sup> Bond, S., M. Hawkins, & A. Klemm (2005).

<sup>227</sup> Liu, S., & Z. Zhu (2009): 'Transaction Costs and Price Volatility: New Evidence from the Tokyo Stock Exchange'. Journal of Financial Services Research 36/1, 65-83.

<sup>228</sup> Becchetti, L., M. Ferrari, & U. Trenta (2014): 'The Impact of French Tobin Tax'. Journal of Financial Stability, 15, 124-148.

<b>Neutral / No Significant Effect</b>			
Saporta & Kan (1997) <sup>229</sup>	Changes in UK stamp duty	1963 – 1996	No effect on volatility
Roll (1989) <sup>230</sup>	Stock returns of 23 countries	01/02/1987 – 10/09/1987	Inverse relationship insignificantly correlated with volatility
Lindgren (1994) <sup>231</sup>	Review of 11 years of quarterly data of 14 stock markets in different countries	11 years	No effect, positive or negative (clustering by size; high tax rates increase volatility)
Hu (1998) <sup>232</sup>	14 changes in transaction taxes in four markets: Hong Kong, Japan, Korea, Taiwan	1975 - 1994	No evidence of change in volatility
Sahu (2008) <sup>233</sup>	Securities transaction tax in India	2004 (+/- two years)	No evidence of change in volatility and does not distort liquidity
Umlauf (1993)	Transaction tax on brokerage service providers in Swedish	1980 - 1987	Increase in transaction taxes did not cause volatility to decline.
<b>Mixed Result s</b>			
Phylaktis & Aristidou (2007) <sup>234</sup>	Effect of transaction tax of 0.3% on Greek Stock Market	24/9/1997 – 31/12/2003	Increased volatility during bull periods, and decreased volatility during bear periods

If policy makers are correct, and the Proposal does achieve its objective, a reduction in speculation may not necessarily be beneficial for participating Member States. The volume of financial transaction around the world have increased dramatically in recent years. In 2007, trade in financial instruments accounted for 70% of world GDP.<sup>235</sup> It is clear that any effort to reduce speculative trading will affect the marketability of shares<sup>236</sup> and reduce trading volumes.<sup>237</sup> What is uncertain is the extent to which volumes will be reduced. Any change in trading volumes will consequently affect liquidity.<sup>238,239</sup> This is an important issue and may be

<sup>229</sup> Saporta, V., & K. Kan (1997): 'The Effects of Stamp Duty on the Level and Volatility of UK Equity Prices'. Bank of England Working Paper, 71.

<sup>230</sup> Roll, R. (1989): 'Price Volatility, International Market Links, and Their Implications for Regulatory Policies'. Journal of Financial Services Research, 3, 211-246.

<sup>231</sup> Lindgren, R. (1994): 'Transaction Taxes and Stock Market Volatility'. Stockholm School of Economics, Working Paper, 59.

<sup>232</sup> Hu, S. (1998).

<sup>233</sup> Sahu, D. (2008): 'Does Securities Transaction Tax Distort Market Microstructure? Evidence from Indian Stock Market'. Available at SSRN: <http://ssrn.com/abstract=1088348>.

<sup>234</sup> Phylaktis, K., & A. Aristidou (2007): 'Security Transaction Taxes and Financial Volatility: Athens Stock Exchange'. Applied Financial Economics, 17/18, 1455-1467.

<sup>235</sup> Darvas, Z., & J. v. W. Weizsäcker (2010).

<sup>236</sup> Pomeranets, A. (2012).

<sup>237</sup> Grundfest, J. A., & J. B. Shoven (1991): 'Adverse Implications of a Securities Transactions Excise Tax'. Journal of Accounting, Auditing and Finance 6, 409-42.

<sup>238</sup> Pellizzari, P., & F. Westerhoff (2009).

<sup>239</sup> Dietlein, G. (2012).

difficult to balance with changes in market behaviour.<sup>240</sup> A reduction in liquidity also imposes a challenge for companies seeking to raise capital.<sup>241</sup> It may have a totally different impact if market conditions are right – an increase in price impacts may actually cause an inverse reaction.<sup>242</sup> But in general this has not been the case and the introduction of transaction taxes has generally lead to a reduction in market volumes, with a greater effect noted in markets where higher volatility and noise traders<sup>243</sup> exist.

Campbell & Froot<sup>244</sup> state that the impact on volume (and hence liquidity) is ‘sensitive’ to the way in which the tax is implemented, but its effect is reduced if market makers can produce enough liquidity in the market to compensate for this.<sup>245</sup> Further analysis of empirical results, focusing on the framework of the transaction tax being studied, could improve our understanding of how markets react.<sup>246</sup> This includes not only looking at how the tax was implemented but also looking at the underlying objectives of the transaction tax being studied. Whilst transaction taxes inspired by Keynes and Tobin focus on market stability,<sup>247,248</sup> revenue generation has been the main priority in many other transaction taxes.<sup>249</sup> This may make comparison difficult in some respects, even if the Proposal creates a new revenue stream for the European Union.<sup>250</sup>

Another issue that needs to be addressed here is that FTT is not specific in its objective to target speculative trading. As a result, financial instruments used in everyday operations will also be affected given also the limited scope of exemptions available under the Proposal.<sup>251</sup> This will mean that derivatives which are used for hedging against business risk are still subject

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<sup>240</sup> Mende, A., & L. Menkhoff (2003): ‘Tobin Tax Effects Seen from the Foreign Exchange Market's Microstructure’. *International Finance* 6/2, 227–247.

<sup>241</sup> Matheson, T. (2011).

<sup>242</sup> Heaton, J. & A. Lo (1995): ‘Securities Transaction Taxes: What Would be Their Effects on Financial Markets and Institutions?’ in S. Hammond, (eds.) *Securities Transactions Taxes: False Hopes and Unintended Consequences*; Chicago IL: Catalyst Institute.

<sup>243</sup> Song, F., & J. Zhang (2005): ‘Securities Transaction Tax and Market Volatility’. *The Economic Journal*, 115, 1103–1120.

<sup>244</sup> Campbell, J. Y., & K. A. Froot (1994).

<sup>245</sup> Pellizzari, P., & F. Westerhoff (2009).

<sup>246</sup> Campbell, J. Y., & K. A. Froot (1994).

<sup>247</sup> Spahn, P. B. (2002): ‘On the Feasibility of a Tax on Foreign Exchange Transactions’. Report to the Federal Ministry for Economic Cooperation and Development, Bonn.

<sup>248</sup> Pellizzari, P., & F. Westerhoff (2009).

<sup>249</sup> Honohan, P., & S. Yoder (2010, p. 11) note that in the case of bank debit taxes ‘The transactions taxes that have actually generated the biggest revenues in practice have had a much more limited base. The most important of these have been in Latin America, where they have generally been introduced for revenue purposes’.

<sup>250</sup> Proposal for a Council Decision on the system of own resources of the European Union Brussels, 29.6.2011, COM(2011) 510 final.

<sup>251</sup> Murre, D. (2012): ‘The European Financial Transactions Tax: Issues for Derivatives, Structured Products and Securitisation’. IBFD, *Derivatives and Financial Instruments*, 4/1.

to FTT even though they have no speculative motive.<sup>252</sup> This causes a ‘disincentive for risk management’<sup>253</sup> and ‘[discourages] risk-taking by imposing positive costs on both good and bad realisation’.<sup>254</sup> The impact on repo transactions, commonly used for trading, has also generated concern as there are few alternatives to the use of repos for collateral purposes.<sup>255</sup> Even if it may be difficult to make a distinction between speculative and non-speculative transactions,<sup>256</sup> adoption of exemptions in line with FTT recently introduced in Italy<sup>257</sup> deserves further consideration as it may help to reduce the burden of FTT where transactions are unlikely to have a speculative motive.

## **2.3. Compliance Considerations**

### **2.3.1. Cash Flow Considerations**

Under conditions of uncertainty the additional cost of FTT on trading could, in some cases, significantly outweigh the potential benefits. Features of FTT particularly make this tax design burdensome on the cash flow management of companies. Key to this is that FTT is charged in all cases, with very limited exemptions and no deductions at all against the taxable amount due. Not all transactions undertaken are profitable, but FTT is charged nonetheless. The issue of profitability is not generally considered in indirect taxes, but unlike many other indirect taxes where deductions are allowed for inputs, such as in the case of VAT, FTT does not permit any deductions whatsoever. Furthermore, FTT is even charged when transactions are cancelled and no exchange of financial instruments takes place.<sup>258</sup> The latter may have a significant impact on cash balances if the underlying value of the cancelled transaction is significant. The lack of consideration for trading losses also increases the burden of FTT, but

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<sup>252</sup> The OECD recognizes the increasing use of hedging by companies as ‘a financial risk management tool’. They are used by companies to neutralize the risks of doing business including exposure to currency exchange, changes in interest rates or risk of non-execution of transactions by all contractual parties. See OECD (2013): ‘Aggressive Tax Planning based on After-Tax Hedging’. OECD Publishing, p. 13. Such views are also supported by financial institutions found in third countries, who also strongly oppose FTT. See Open letter by the Australian Financial Markets Association, Global Financial Markets Association, Investment Industry Association of Canada, Japan Securities Dealers Association, Korean Financial Investment Association, ‘Opposition to the EU’s Proposed FTT’. Addressed to G-20 Financial Ministers, 16 April 2013. Available at: <http://www.gfma.org/correspondence/item.aspx?id=464>.

<sup>253</sup> Oxera (2011), p. iv.

<sup>254</sup> Matheson, T. (2011), p. 13.

<sup>255</sup> Comotto, R. (2013).

<sup>256</sup> Kavelaars, P. (2012).

<sup>257</sup> Both the FTT in Italy and France incorporate certain exemptions which ring-fence transactions and activities which are not considered as speculative in nature. This includes exempting ethical and socially responsible products and services, as well as pensions, and more importantly bonds.

<sup>258</sup> Article 5(2), COM(2013) 71 final.

such considerations are generally only a feature of direct taxes. As already outlined above, it may also necessitate the restructuring of groups located in the enhanced cooperation zone, especially EU-based companies providing treasury services.<sup>259</sup> The cash flow burden may also differ across Member States if Member States choose to implement tax rates which differ to minimum rates established by the Proposal.

Additionally, the notional basis of taxation for derivative instruments makes FTT particularly burdensome for companies. The use of notional values seeks to reduce compliance and administration costs,<sup>260</sup> but would also significantly increase the tax base of derivative instruments subject to FTT. Where realisation has not taken place, a lack of internal funds will require companies to seek third-party financing. This would be the case for all instruments subject to FTT, but the impact may be greater for derivatives given the significant notional value of such instruments. Furthermore, financing may not readily be available, or only available at a premium. The lower tax rate on derivative instruments does little to mitigate this drawback, other than creating an investment bias.<sup>261</sup> Erratic cash flow requirements also create difficulties for financial planning that has repercussions for the company as a whole. A change from a notional tax base to a cash (based on settlement date), accrual (date of transaction, transfer or contract date) or hybrid basis of taxation<sup>262</sup> would improve cash flow management. Application of purification principles would also help to reduce the cash flow burden by giving due consideration to exempt underlying instruments.<sup>263</sup> Other taxes that have been found to cause similar cash flow issues include wealth taxes which have, as a consequence, been progressively eliminated across Europe.<sup>264</sup>

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<sup>259</sup> Domestically groups may be subject to special tax considerations including exemptions or tax deferral, roll-over relief and / or loss offset provisions, enabling groups to be treated as one economic unit for tax purposes. Within Europe, directives, such as the Merger and Acquisition Directive seek to remove fiscal obstacles in cross-border reorganizations while the Parent-Subsidiary Directive and the Interest and Royalty Directive seek to reduce the tax burden on cross border transfers between group members. Under FTT, group structures will be faced with an added burden, given that transactions may arise where no consideration changes hands and where, fundamentally, no purchase or sale may have arisen – See COM(2011) 594 final. Nevertheless, the transaction still attracts a tax charge, as well as accompanying compliance obligations. As a result, merger and acquisition decisions across Europe may still be distorted as companies look at the impact of FTT after reorganization takes place within participating Member States. FTT may thereby suffer the same criticism as has been levied on the impact that UK stamp duty taxes have on merger and acquisition decisions. See Hawkins, M., & J. McCrae (2002).

<sup>260</sup> Explanatory Memorandum to COM(2011) 594 final.

<sup>261</sup> AIMA Research Note (2012).

<sup>262</sup> Brondolo, J. (2011).

<sup>263</sup> The application of purification principles would benefit all trades subject to FTT.

<sup>264</sup> There were found to contribute both to a drain on capital and distort resource allocation. See Ristea, L., & A. Trandafir (2010): 'Wealth Tax within Europe in the Context of a Possible Implementation in Romania: The Existing Wealth Tax and Its Decline in Europe'. *Annals of the University of Petroșani: Economics*. 10 (2), 299-306.

### 2.3.2. The Proposal

Authorities may favour transaction taxes for a number of reasons. Transaction taxes are generally viewed as easier to administer, and less costly to collect especially when they are carried out electronically.<sup>265</sup> In the latter case, FTT also provides real time revenue flows to authorities.<sup>266</sup> In addition, the broad scope of the tax would make it less susceptible to tax avoidance, making FTT technically ‘feasible’ and ‘timely’.<sup>267</sup> But a number of compliance and administration issues make implementation of the current Proposal difficult. This includes a tax base which is not clearly defined,<sup>268</sup> whilst no definition at all exists on how entities operating with the enhanced cooperation zone will be considered as forming part of a group or whether for that matter how those located outside the zone will also be treated.<sup>269</sup> Further difficulties may arise because FTT is not linked to the transfer of legal ownership of financial instruments.<sup>270</sup> The Proposal has also not taken into consideration joint ownership of financial instruments, nor how neutrality is safeguarded when differences in legal characteristics arise in different Member States. This may lead to conflicts in treatment across Member States.

The use of notional values also poses a problem for implementation of the Proposal. Despite the fact that the Proposal does define notional values,<sup>271</sup> financial instruments are often quite complex and it may be difficult in practice to apply this definition. A case in point is the valuation of derivative products for which underlying values are not available at the moment when a transaction is subject to liability. Given the short time frame in which payment is to be

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<sup>265</sup> Transaction taxes in the UK in the form of UK stamp duty has been found to be one of the cheapest taxes to collect, far cheaper than direct taxes such as corporation tax. See Bond, S., M. Hawkins, & A. Klemm (2005).

<sup>266</sup> Under FTT payment is required within three days from date of the transaction. See Article 11(5), COM(2013) 71 final.

<sup>267</sup> Conway, E. (2009): ‘Joseph Stiglitz calls for Tobin Tax on All Financial Trading Transactions’. The Telegraph. 5 October. Available at: <http://www.telegraph.co.uk/finance/financialcrisis/6262242/Joseph-Stiglitz-calls-for-Tobin-tax-on-all-financial-trading-transactions.html>.

<sup>268</sup> Such as whether tax is due on the trade or settlement date.

<sup>269</sup> Although no beneficial tax provisions for groups are provided in the Proposal (other than in the case of reorganization), anti-avoidance provisions are specifically mentioned with respect to groups. In this regard transactions between group members should be undertaken at arm’s length. In addition, the absence of harmonized anti-avoidance legislation across Europe (and internationally) in terms of the establishment of the arm’s length principle may also give rise to implementation and administrative problems for companies operating within the enhanced cooperation zone. Groups will have to satisfy rules in multiple jurisdictions with varied and often complex compliance requirements. Neither companies nor authorities located within jurisdictions currently free of such anti-avoidance rules will be relieved of such obligations. The latter will only add to initial teething problems.

<sup>270</sup> Transaction taxes have traditionally been linked to the transfer of ownership. Under FTT all transfers, whether giving rise to transfer of ownership or not are now subject to FTT. This means that even intermediary transfers are taxable. This may give rise to considerable costs increasing the cascading effect of FTT. FTT will impose a tax and compliance burden on intermediaries who have generally not be subject to transaction taxes but who now will be required to have the appropriate framework in place.

<sup>271</sup> ‘The underlying nominal or face amount that is used to calculate payments made on a given derivative contract,’ Article 2(12), COM(2013) 71 final.



made, especially in the case of electronic transfers, this may pose practical problems for financial institutions. Notional values may also differ considerably from actual consideration paid.<sup>272,273</sup>

Necessity, the mother of all inventions, is equally applicable within the sphere of tax planning, and hence we will also see new instruments placed on the market by financial engineers. The use of factoring in derivative instruments will consciously increase given the lack of anti-avoidance provisions in this respect, although the ‘robustness of the tax’ has already been reviewed.<sup>274</sup> Swaps are particularly suited for factoring given that they lack any principle values.<sup>275</sup> The principle of ‘substance over form’ should apply to minimise evasion and avoidance,<sup>276</sup> but here too the sector can be very creative.

Technical problems may also hamper implementation. Concern have been raised regarding who will be responsible for tax payments in the case of custodian services and whether compliance requirements will also be imposed on them.<sup>277</sup> Clear guidelines has not yet been published by the Commission, making implementation difficult. Also the distinction between transactions which fall within the scope of the Proposal and those that are exempt, is not always clear. Although the Proposal seeks to comply with the Capital Duties Directive, there are instances where the application of the latter has given rise to confusion. In *Commission v. Belgium*<sup>278</sup> the issue of shares was shown to include also delivery of those securities to subscribers, and applies similarly to bearer securities. As a result, Belgium – in levying stock exchange taxes on such transfers – failed to abide by Council Directive 69/335/EEC of 17 July 1969, which bars Member States from levying indirect taxes on the raising of capital. In the UK, an incorrect interpretation by HMRC resulted in claims for refunds of stamp duty reserve tax (SDRT) after HMRC was found to have wrongly imposed SDRT on the issuance of shares into clearance services. In *HSBC Holdings Ltd and Vidacos Nominees v. The Commissioners for HM Revenue & Customs*,<sup>279</sup> the payment was considered to amount to a tax on capital and could not be justified.

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<sup>272</sup> Murre, D. (2012).

<sup>273</sup> Hemmelgarn, T., & G. Nicodème (2010).

<sup>274</sup> Englisch, J., J. Vella, & A. Yevgenyeva (2013).

<sup>275</sup> Matheson (2011).

<sup>276</sup> Commission Staff Working Document of 14 February 2013 Impact Assessment, Accompanying the document Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, Analysis of policy options and impacts, SWD(2013) 28 final.

<sup>277</sup> Open Letter Addressed to Commissioner Algirdas Šemeta from the Association of Global Customers Re: Financial Transaction Tax of 9 January 2013. Available at: <http://www.theagc.com/2013-01-09%20Letter%20from%20AGC%20to%20EC%20regarding%20FTT.pdf>.

<sup>278</sup> Case C-415/02.

<sup>279</sup> Case C-569/07.

The complexity and innovative nature of the financial sector and the diverse range of instruments that exist may further add to implementation problems, especially where tax authorities lack sufficient staff and administrative technical support. As Braithwaite and Wenzel<sup>280</sup> highlight, ‘systems, no matter how elegant, rely on people to work, and if the assumptions made about people, either those who work as tax collectors or those who pay taxes, are incorrect, there is no reason for expecting that tax design by the gold standards will achieve the desired outcomes’.

#### **2.4.2. Arguments in Favour of Standard Implementation Procedures**

Member States will be made responsible for all administrative, accounting and reporting obligations<sup>281</sup> under FTT. Harmonization in the form of standardized practices could prove beneficial in this case. The Commission does recommend that Member States should take advantage of existing and forthcoming EU legislation on financial markets<sup>282</sup> but this provides little support for financial institutions in third countries who may have little knowledge of such legislation. Furthermore, participating Member States may have differing interpretations on best practices. Cross border transactions may prove cumbersome if no harmonised approach to implementation is affected. Issues such as how transactions in foreign currencies are to be treated can create inconsistencies. Even IT system that facilitate the administration, monitoring and coordination<sup>283</sup> of FTT differ in the way in which they can support tax payment, and there is still no established reporting system for the exchange of information regarding counterparty transactions with financial institutions located in third countries. Transactions carried out off exchanges are even more difficult to monitor. Non-participating Member States and third countries could also benefit from the introduction of standard practices as they will need to support financial institutions located within their jurisdiction who must comply with FTT. If the Proposal is to be implemented in a matter of months, the Commission should provide further guidance in this regard. If FTT is to be

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<sup>280</sup> Braithwaite, V., & M. Wenzel (2008): ‘Integrating explanations of tax evasion and avoidance’. Chapter 13 in A. Lewis, ed. *The Cambridge Handbook of Psychology and Economic Behaviour*. Cambridge University Press, p. 317.

<sup>281</sup> Article 11, COM(2013) 71 final.

<sup>282</sup> Explanatory Memorandum to COM(2013) 71 final.

<sup>283</sup> There are also other advantages of using IT systems to administer FTT including reduced trading costs. The compliance cost with regard to UK stamp duty were found to be relatively less than the costs with regard to other taxes (Bond, S., M. Hawkins, & A. Klemm (2005), Hawkins, M., & J. McCrae (2002)). IT systems also facilitate tax at source which may assist in reducing the compliance burden. However, the preferential use of over-the-counter transactions by traditional stock brokers would mean that such advantages could potentially be lost. In the latter case, those liable to FTT on the basis of a self-assessment system.

introduced in the beginning of 2017, there may be little time left for discussion and agreement by all parties. Presently there is no clear outline on how Proposal will be introduced. Even the best method on how FTT should be actually collected is still being discussed.<sup>284</sup>

### 2.4.3. Accounting and Audit Considerations

During the financial crisis the role of the accounting profession was questioned.<sup>285</sup> The widely held conclusion is that standards (fair value accounting) were unlikely to have contributed to the financial crisis.<sup>286</sup> However, a recurring theme during the debate on the role that the profession played during the crisis was the ‘inconsistent implementation and subsequent misapplication of the standards by originators, securitizers, and investors’.<sup>287</sup> If FTT encourage new innovative financial products, than this will only add to the problem of less than perfect application of standards.

The future role of accounting standards, and the profession itself, has now been questioned. International standards may not be able to support innovative financial products that may develop in response to FTT. If accounting standards do change, the increase in complexity that we may observe may not necessarily add value to accounting statements.<sup>288</sup> The lengthy standard-making process further complicates matters. IFRS 9,<sup>289</sup> issued in

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<sup>284</sup> European Commission (2014): ‘FTT – Collection Methods and Data Requirements’. Specific contract No3 TAXUD/2013/DE/314 based on Framework Contract no TAXUD/2012/CC/117, Final Report Ernst & Young, October.

<sup>285</sup> See Lagneau-Ymonet, P., & S. Quack (2012): ‘What's the Problem? Competing Diagnoses and Shifting Coalitions in the Reform of International Accounting Standards’. In R., Mayntz (Ed.), ‘Crisis and Control: Institutional Change in Financial Market Regulation’. 213-246. Frankfurt: Campus Verlag, and Castleden D. (2009): ‘Are Accounting Standards Responsible for the Global Financial Crisis?’. Accountancy SA.

<sup>286</sup> See Barth, M. E., & W. R. Landsman (2010): ‘How Did Financial Reporting Contribute to the Financial Crisis?’. *European Accounting Review*, 19/3, 399-423., Laux C., & L. Christian (2010): ‘Did Fair-Value Accounting Contribute to the Financial Crisis?’. *Journal of Economic Perspectives*, American Economic Association. 24(1), 93-118., Prochazka, D. (2011): ‘The Role of Fair Value Measurement in the Recent Financial Crunch’. *Prague Economic Paper/1*, 71-88., Jones, M., & R. Slack. (2011): ‘The Future of Financial Reporting 2011: Global Crisis and Accounting at a Crossroads’. ACCA, A discussion paper based on the British Accounting and Finance Association’s Financial Accounting and Reporting Special Interest Group (FARSIG) Symposium, 7 January. Kroeker, J. (2011): ‘Testimony Concerning the Role of the Accounting Profession in Preventing Another Financial Crisis’. US Securities and Exchange Commission.

<sup>287</sup> Kothari, S. P., & R. Lester (2011): ‘The Role of Accounting in the Financial Crisis: Lessons for the Future’. Available at: <http://ssrn.com/abstract=1972354>. p.27.

<sup>288</sup> Discrepancies between financial and tax accounting exist however stakeholders have placed greater pressure on companies to keep them informed of the ‘true value’ of companies in which they have an interest, with greater emphasis being placed on the quality of information provided. See Alworth, J., & G. Arachi (2010), Eberhartinger, E., & M. Kostermann (2007): ‘What if IFRS Were a Tax Base? New Empirical Evidence from an Austrian Perspective’. *Accounting in Europe* 4/2, 141-168.

<sup>289</sup> The need for improvements in transparency and disclosure has encouraged the International Accounting Standard Board (IASB) (working closely with the Financial Accounting Standards Board), to undertake a review of international standards. The introduction of IFRS 9 –Financial Instruments was brought to the forefront of the work of the IASB. The IASB’s ‘overhaul of its standard on financial instruments has been the subject of much attention and scrutiny’ (Grant Thornton (2009): ‘IFRS News Special Edition, IFRS 9 Financial Instruments.’ p.

response to the need to update standards pertaining to financial instruments, may require further review if the Proposal is implemented. Future reform in the financial sector may also require accountants, and auditors, to take a more proactive role in supporting a more stable financial sector.<sup>290</sup>

### **3. How can the Proposal be Improved?**

History has shown that corrective taxation should be undertaken cautiously as both the side-effects and deadweight losses could outweigh any benefits gained.<sup>291</sup> Claessens & Kodres, note that ‘any financial system reform undertaken by policy makers, including new financial transaction tax, must take into consideration the financial system as a whole’.<sup>292</sup> Selected tax instruments must also be efficient and have the least effect on market behaviour.<sup>293</sup>

The Proposal primarily aims to ‘right a wrong’ but empirical research show that transaction taxes have a wider impact than the objectives outlined by the Commission. The Proposal once implemented will have an effect on market behaviour,<sup>294</sup> both before implementation<sup>295</sup> and on the actual day it is introduced. Changes in market behaviour may not necessarily be a bad thing as it would be contradictory to the objectives of the Proposal if FTT did not influence trading behaviour. But it does far more than discourage inefficient trading and reduce market volatility. Table 4 compares the objectives as outlined by the Proposal and the potential unintentional consequences that may arise if the Proposal is implemented. The latter is based on the literature reviewed in this paper. Distortion will arise with implementation of the Proposal, and so too will the relocation of companies from participating Member States. Above all the anti-speculative effect of the Proposal, is as yet, uncertain. In addition, implementation of the Proposal would give rise to higher trading costs, increase redundancies and dampen market liquidity which may all contribute to reducing the international competitiveness of companies operating in the enhanced cooperation zone.

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1) and included reviewing principles for the classification and measurement of assets, impairment methods and accounting for hedging. The increasingly complexities of financial instruments will place increased pressure on the accounting profession.

<sup>290</sup> See Claessens, S., & L. Kodres (2014).

<sup>291</sup> Honohan, P. (2003): ‘Avoiding the pitfalls in taxing financial intermediation’. Policy Research Working Paper Series, 3056, The World Bank.

<sup>292</sup> Claessens, S., & L. Kodres (2014), p. 4.

<sup>293</sup> Hawkins, M., & J. McCrae (2002), p. 7.

<sup>294</sup> SEC(2011) 1102 final.

<sup>295</sup> Both Umlauf (1993) and Bond, Hawkins and Klemm (2005) noted that well before transaction taxes were implemented, the mere announcement of transaction taxes had an effect on markets.

Table 4 – Proposed Directive: Intended Results vs. Unintended Results

Intended Outcomes <sup>296</sup>	Unintended Potential Consequences
1.a. Harmonization ensuring proper functioning of internal market and 1.b. Avoiding distortion of competition	1.a. Semi-harmonization through enhanced cooperation 1.b. Distortion arising for enhanced cooperation zone based companies compared to non-FTT competitors
2.a. Causing financial institutions to make a fair substantial contribution and 2.b. Creating level playing field	2.a. Relocation of business 2.b. See 1.a and 1.b. above
3.a. Providing appropriate disincentives for transactions that do not enhance efficiency 3.b. Avoiding future crisis	3.a. Transaction tax as anti-speculative instrument has provided mixed results (see section 2.2.4.) 3.b. In addition to 2.a., revenue generation may not meet expectations. As a result, sufficient funds would not be available to meet future demands on government to counteract any negative pressures.

The IMF did not hold a favourable view of the Proposal<sup>297</sup> and noted that it may not be the most appropriate way forward.<sup>298</sup> Although the debate makes us question if there are better alternatives to FTT,<sup>299</sup> it is unlikely that the Commission will now change its position on adopting the Proposal. In this situation we must work within the framework of the existing Proposal and implement changes which could help foster outcomes that are more in-line with the intended objectives of the Proposal and that would encourage greater adoption across the board. Present discussions have focused on reviewing the scope of the Proposal and reassessing which instrument should be subject to FTT. In addition, there is growing emphasis that there needs to be a change to residence and issuance principles incorporated within the Proposal.<sup>300</sup> This would reduce the extraterritorial effect of the Proposal and help to counteract any distortive effect that may arise. If changes to the Proposal are to be made, the Commission would do well to consider revamping the Proposal on a number of other key issues as well. It must also place greater emphasis on providing clearer guidance on specific areas to companies that will be affected by the Proposal. It is obvious that there are many aspects to consider, and there are many and divergent views on the way forward, but in light of the discussion above,

<sup>296</sup> COM(2013) 71 final.

<sup>297</sup> Staff of the International Monetary Fund (2010).

<sup>298</sup> Claessens, S., M. Keen, & C. Pazarbasioglu, eds. (2010).

<sup>299</sup> Darvas, Z., & J. v. W. Weizsäcker (2010).

<sup>300</sup> ‘Germany’s Schaeuble Calls Financial Transaction Tax Negotiations ‘Laborious’,’ International Tax Monitor, Tax and Accounting Center, Bloomberg BNA, May 6, 2015 – Number 89. Online Magazine.

the following issues should also be considered:

- a. The establishment of coordination authority providing standardised reporting, accounting and collection support and guidance for participating and non-participating Member States, as well as third countries that must ensure enforcement at national level,
- b. Guidance notes on key principles such as definition of groups and taxable event,
- c. The adoption of intra-group exemptions<sup>301</sup> on non-speculative trades undertaken between entities in a group, whilst incorporating at the same time provisions which reverse the benefits of exemptions when subsequent transfers are made outside of the group after a minimum holding period is applied,
- d. Greater specificity within the Proposal that places emphasis on high-frequency trading and highly leveraged transactions,
- e. Ring-fencing provisions for genuine business risk hedging, by increasing the scope of exempt transactions to include bone fide business risk hedging, which is required for general trading,
- f. Excluding non-executed transactions from the scope of the Proposal, whilst incorporating specific provisions to safeguard against manipulative trading behaviour,
- g. Reassessment of the use of notional values for derivative instruments, particularly in the case of non-realisation,
- h. Consideration of purification provisions for exempt underlying trades,
- i. Change in the timing of the taxable event, with due consideration of realisation based on consideration for cash, accruals or hybrid basis for taxation,
- j. Limiting the extraterritorial effect of FTT to safeguard foreign direct investment from third countries, implementing at the same time beneficial ownership provisions to safeguard against abuse.

From the alternatives presented in Section 1.3. and the points a. to j. raised above, the merits of VAT deserve further reconsideration. Without adopting a fully-fledged VAT system

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<sup>301</sup> If a tax is to be charged, the burden of FTT could be reduced in other ways by allowing for compensatory adjustment with respect to direct tax levied on investment income, reflecting a proportionate reduction in the tax burden arising from (higher) transaction costs between groups. Alternatively, deductibility of the tax charge against corporate taxation or profits is also another alternative means to mitigate the tax burden on groups. If it is not seen as feasible to exempt groups from FTT in its entirety, a lower rate of FTT specifically applicable to group transactions may also prove beneficial.

for the taxation of financial instruments, the EU VAT system offers an existing framework for implementation of FTT and incorporates a number of administrative and compliance procedures that could add value to the current Proposal.

One of the most difficult challenges of the Proposal is implementation of the Proposal itself. Both the cost and technical difficulties that companies will face discourages adoption and encourages relocation of activities. VAT provides an existing framework for implementation which could help to develop a parallel administration system for FTT or provide a platform in itself to facilitate compliance and administration as well as coordination between Member States. It would also provide benefits for third countries which already have experience in dealing with VAT when undertaking transactions with companies in the European Union. In short, FTT could use the same reporting framework available for VAT, including registration of financial institutions, which could compliment, or replace, the current system of identification of financial services.<sup>302</sup> VAT also provides for the submission of returns, with payment, periodically allowing for an extended period between realisation and payment which would reduce the cash flow burden on companies and allow greater opportunity for the realisation of financial instruments to take place. The system of registration under VAT which is supported by the VAT Information Exchange System (VIES) would greatly facilitate the identification of counterparties and reduce the risk of joint and several liability by confirming that counterparties are in fact registered for payment of FTT. The same registration system could be used, or alternatively a new one developed along the same framework. The use of recap statements framework which is a compliance requirement under VAT could also help participating Member States overcome some practical difficulties in identifying and assessing counterparties and furthermore allows reconciliation by authorities in different Member States to take place in a standardised way. This would greatly facilitate the auditing of cross border transactions and ensure that the basis for valuation between different countries is the same. VAT also incorporates group ring-fencing provisions,<sup>303</sup> with established criteria for the identification of groups and reporting requirements. The use of VAT principles here would facilitate the development of guidelines on exemption basis for intra-group transfers undertaken within the scope of the Proposal without having to develop a new system for guidance or interpretation. Reverting to a fully-fledged VAT system that taxes the financial

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<sup>302</sup> The Commission notes that financial institutions could be identified use existing Business Identification Codes (BIC/ISO 9362), the Classification of Financial Instruments (CFI/ISO 10962) or the Market Identifier Code (MIC/ISO 10383). See Explanatory Memorandum to COM(2013) 71 final.

<sup>303</sup> VAT group option provided for in Article 11 of Council Directive 2006/112/EC on the common system of value added tax.

sector may not be the way forward, but that does not mean that the advantages that are offered by this tax instrument should be completely ignored.

#### **4. Conclusions and Outlook**

The Proposal has to date remained just that, a Proposal. Recent setbacks shed light on pressure to refine the Proposal and make it more acceptable to those who must implement it. Non-participating Member States in particular have voiced their concern regarding the extraterritorial effect of the Proposal and recent comments by the European Council Legal Service sheds doubt on the application of FTT as it currently stands. Although the Commission did not agree with the conclusion of the Council, the overwhelming evidence shows that as the Proposal needs to be reassessed not only to address the potential unintentional impacts that may arise as a consequence of the Proposal, but also to ensure that greater adoption is achieved by those States who have currently opted out of the enhanced cooperation agreement.

Greater harmonisation would remove many of the potential negative consequences on competition for companies located within the enhanced cooperation zone. Widespread adoption will only take place if the Commission is willing to reassess its position and adopt a more flexible approach to taxing financial transactions across Europe. This includes a reassessment of the scope and tax base and many other aspects which have already been mentioned above, while keeping the possible effect on the competitiveness of companies in mind. The seeds of change may however have already been planted. Algirdas Šemeta, the European Union's Taxation Commissioner has been quoted as saying that 'we would support a compromise with a more limited remit [...] the only red line for us is that any loopholes which would jeopardise the main principle of the tax be avoided'.<sup>304</sup> Such flexibility from the Proposal as it currently stands may mean that it would be embraced by other Member States and with greater adoption also comes a reduction in the distortive effect of FTT. The Commission may need to find its own spoon full of sugar to make FTT more palatable to all concerned.

Although the wide basis of taxation found within the Proposal encourages neutrality, it cannot compensate for the lack of harmonisation of transaction taxes. Given the mobile nature of trading, neutrality is far from certain. The Commission must be willing to monitor closely the real effects of the tax. Support must be provided to the business community by authorities located both in participating and non-participating Member States.

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<sup>304</sup> Hudson, A. (2013): 'EU Would Accept Watered-Down Transaction Tax'. Reuters. 29 December. Available at: <http://uk.reuters.com/article/2013/12/29/uk-eu-tax-transaction-idUKBRE9BS07G20131229>.



If FTT is to be introduced by the beginning of 2017, the biggest question that now remains is how the Proposal is going to be implemented across companies operating in different jurisdictions. Previous alternative means to tax the financial services sector can provide inspiration for revamping the Proposal. The framework for implementation of VAT could provide added value to the Proposal and stream line processes for smoother implementation. It could also help to clarify a number of key issues such as providing a definition for group structures, and a framework for counterparty confirmation. The complexity and uncertainty that currently overshadows the Proposal is far too great for the Commission not to take a stand.

Notwithstanding that this paper has focused on the business perspective of the Proposal, the initial considerations of why FTT was first discussed should not be overlooked. Following the polluters pay principle, the tax seeks to overcome some of the drawbacks that the market cannot compensate for. A transaction tax may be the only way to reduce excess speculation. Even if not proven in all cases, it does ensure that those who have contributed to the crisis pay, in some way, for the damages they have caused. Through its broad nature and the principle of extraterritoriality, the Proposal also ensures that companies that should pay, do, as there are very few opportunities to avoid the tax, if at all. FTT may not be entirely beneficial from a business perspective but may still have an important social role to play in regulating the market. It may be a necessary constraint required by a market which has been found unable to restrain itself.

The impact of this innovative tax and whether or not it will be able to address the underlying objectives it purports to achieve has yet to be seen. If it misses its target it may cause more harm than good. Although the past is no guarantee of the future, history does have a habit of repeating itself. Can Europe weather another economic storm if it misses its mark?