TECHNICAL FICHE[1]
MACROECONOMIC IMPACTS

As explained in the Impact Assessment accompanying the *Proposal for a Council Directive on a Common system of financial transaction tax and amending Directive 2008/7/EC (SEC(2011) 1102)* the use of Dynamic Stochastic Equilibrium (DSGE) models is a standard procedure of estimating the macroeconomic effects of policy changes.

Their advantage over sector-specific Partial Equilibrium Models is that they fully take into account spill-over effects to other sectors as well as second-round effects triggered by a policy change, including the effects of the recycling into the economy of higher tax revenues. One possible disadvantage is that they typically have a less detailed sectoral breakdown of the economy than partial equilibrium models.

In order to assess the macroeconomic impacts of taxes on financial transactions specifically, a new DSGE model has been developed. The version of the model used for the Impact Assessment was built on the assumption (amongst others) that all investment is financed with the help of issuing new shares, and that a fall in the price of shares works as a financing constraint for new investment and will hence trigger a decline in overall investment.

The model is a two-period (comparing two equilibriums) and closed-economy model. It includes hypotheses in terms of relocation and market reaction and, in the absence of specific information on the speed of the process, the assumption is made that the new "steady state" would be reached after 40 years[2].

1. THE IMPACT AS DEFINED IN THE IMPACT ASSESSMENT

As stated in the Impact Assessment accompanying the directive proposal, the estimation of the possible cumulative deviation of GDP was established at -0.53% in the long run. This means that (when assuming in the baseline an annual growth of 1.5%) in 2050, instead of GDP in Europe being 81.4% above today's level, it would be 80.9% above that level.

[1] This technical fiche should be considered as a non-paper that commits only the Commission's services involved in its preparation.

[2] In multi-period DSGE models, it typically takes several decades until the new equilibrium is reached. So as to remain consistent with other long-term modelling approaches (such as energy, transport and climate roadmaps) or long-term scenarios (such as demographic scenarios), the year 2050 was chosen.

The model could not take into account the full concrete design of the tax as defined in the proposal. It was also based on the strong assumption that all new investment had to be exclusively financed with the help of issuing new shares that are traded and subject to the tax. As a result, the mitigating effects included in the proposal remained outside the model simulations and were taken into consideration ex post. This held namely for:

- the exclusion of primary markets from taxation,
- the exclusion of transactions that do not involve financial institutions or only non-EU parties,
- the ring-fencing of financial sources for investment that do not rely on securities.

2. MODELLING THE MITIGATING EFFECTS

Since the Impact Assessment was carried out, the model has been further developed. In particular, the assumption that all investment has to be financed with the help of issuing new shares has been changed to take into account the fact that companies also have access to alternative sources of finance that are not subject to the tax. This holds notably for the bulk of European enterprises (more than 95% if taken by number) not listed on stock exchanges and neither issuing shares nor other securities.

The additional model specifications[3] allow for the assumption that only a part of the sources of financing are affected by the tax on financial transactions. Indeed, securities-based financing is only partly affected by applying the tax (primary markets are excluded) and - more importantly - other forms of financing (such as borrowing from banks or the raising of capital through venture capital funds) are not taxed. Depending on the source and method applied[4], these alternative and untaxed finance sources represent between 60 and 80% of all financing of investment. In the central scenario (assumed to be a conservative one), it is assumed that these alternative and untaxed finance sources represent 70%.

Under these assumptions, the estimation of the possible deviation of GDP was established at -0.28%, as the tax is simulated to increase the cost of capital by about 7 basis points in this scenario. As a consequence, in such a scenario, instead of being 81.4% above today's level, the European GDP in 2050 would have risen by 81.1% above today's level.

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[3] For more details on the model specifications *see Lendvai, Raciborski, Vogel* (ECFIN Economic paper 540).

[4] The sources of financing of companies are generally assumed to be new equity (10%), retained earnings (55%) and debt (35%). The share of debt securities in total debt of non-financial corporations is estimated at about 15% (or about 5% of total financing). Hence, assuming bank debt and retained earnings are ring-fenced, the share of corporate financing that would be directly affected by the FTT is about 15% of the total. See for more details e.g. SEC(2011)1102, p 52 (method: Devereux-Griffith methodology, sources: ECB (2010), BIS quarterly Review June 2011). Assuming that other sources of financing (such as the retained earnings of listed companies) were also affected by the tax, this ratio could rise to about 20 to 40%.

Also, and as was highlighted in the Impact Assessment as well, these model simulations assume the recycling of revenues generated by the FTT back into the economy with the help of lump-sum transfers to private households, so as to keep the Debt-to-GDP ratio constant and so as to allow for isolating the "distortionary" impact of the tax from other distortions.

Through this, the model paints a modest negative impact of the tax on economic efficiency and, thus, on GDP. An alternative scenario which lowers e.g. labour or corporate tax rates instead of lump-sum taxes to rebate FTT revenues would lead to a more favourable picture for overall economic efficiency and, thus, economic growth.[5]

The same held if the tax revenues collected were spent – be it at the European or be it at the national level - on growth-enhancing public investment. Here, model simulations show a positive impact of such spending (as compared to providing lump-sum transfers to private households) in the order of magnitude of 0.2% to 0.4% of GDP.[6]

[5] For more details see *Lendvai, Raciborski, Vogel* (ECFIN Economic paper 540)

[6] European Commission, DG ECFIN (2012): Quarterly Review of the Euro Area (forthcoming)

Technical fiche[1]

Pension funds in the context of the FTT proposal

1. Methodological considerations and interpretation of the legal provisions

The reference to pension funds in the context of the proposal for a directive for a common system of FTT is to Institutions for occupational retirement provision (IORPs) regulated by the Directive 2003/41/EC (see Article 2.1(7)(f)). The quoted article also covers their specialised managers, especially for the case in which these institutions – which are usually the funds itself – are not legal persons. Such institutions are private and are completely separate from the public (government-managed) schemes (under public law), so in this context we will actually discuss only about the **private** pension funds (under private law).

Directive 2003/41/EC defines the 'institution for occupational retirement provision' as "*an institution, irrespective of its legal form, operating on a funded basis, established separately from any sponsoring undertaking or trade for the purpose of providing retirement benefits in the context of an occupational activity on the basis of an agreement or a contract agreed:*
- individually or collectively between the employer(s) and the employee(s) or their respective representatives, or
- with self-employed persons, in compliance with the legislation of the home and host Member States, and which carries out activities directly arising therefrom."

This IORP directive specifically excludes in Article 2.2 institutions operating social-security schemes, institutions which operate on a pay-as-you-go basis etc. If one refers to the old methodology developed by the World Bank in the 1990s[2], only what is usually known as the second and third pillars would be covered by the provisions of the FTT directive, so the potential impact on pensioners of the FTT could be limited with regard to the first pillar.

[1] This technical fiche should be considered as a non-paper that commits only the Commission's services involved in its preparation.

[2] The model of the World Bank, intended as a blueprint for developing/transition countries, consists of (I) public pay-as-you-go (PAYG) pensions, (II) mandatory, privately managed pensions (occupational schemes), and (III) voluntary (private) individual accounts (without any link to the employment status).

While pillar I is currently indeed the most important part in many Member States (though not in all), the trend towards pillars II and III is rather strong due to the pressure of demographic changes on pillar I[3]. Notably, the Netherlands, Ireland, United Kingdom, Sweden, Denmark, Germany and Belgium are the Member States which have a significant funded occupational pension sector (often called pillar II pensions) today. Additionally, Finland is running a statutory funded scheme (other funded pensions are not yet all that significant for most of those retiring today). For the future, the mandatory funded schemes in the Member States from CEE will grow and mature and become more significant. Existing pillar II schemes are expected to expand; notably, in the UK next year they are launching a new national occupational pension scheme and automatic enrolment into schemes which is eventually expected to result in an extra 5 million people being covered by pillar II pensions.

Pillar III pensions (individual voluntary contracts normally between individuals and insurance companies and incentivized by governments normally via tax breaks) are only significant in a few Member States and even there they are not as important as occupational pensions for most of the people. Germany, with its "Riester Rente", is the most obvious case; one can also refer to the Czech Republic, the United Kingdom and Ireland. Nevertheless, there is a somewhat "grey area" between long-term savings products and individual private pensions[4]. Another issue to bear in mind is that in many cases[5], pillar III is more addressed to higher income groups as a top up to other pensions, rather than something utilized across all income groups because (a) it requires spare income in order to make the voluntary savings in the first place and (b) incentives often come in the form of tax breaks and as tax systems are progressive, tax incentives are often regressive.

2. The size, asset structure and investment strategies of private pension funds

2.1 Size and importance

[3] PAYG pillar I pensions are perceived to become less "generous" (as they are reformed to enhance their sustainability/react to the economic crisis) and hence less significant proportionately in the overall pension income of individuals.

[4] There is a good case for arguing that the the Czech Republic has in place long term savings products, not individual pensions.

[5] The "Riester Rente" in Germany should be seen as an exception due to the progressive nature of the incentives.

The relative importance of (private) pension funds (pillar II pensions) is very different across the European Union. It is the highest in the Netherlands (135% of its GDP or around EUR 850 bn. in 2010) followed by Finland (82% of the Finnish GDP). In Denmark and Ireland it corresponds to around 50% of GDP, while in countries like Germany, Austria and Italy it reaches around 5% of GDP. In some of EU10 Member States, such as Poland or Hungary, these pension funds have accumulated assets corresponding to around 15% of GDP. However, in some other Member States, such as Belgium, Slovenia, France or Greece the accumulated assets of such funds are significantly below 5% of GDP.[6]

2.2 Portfolio structures and investment strategies

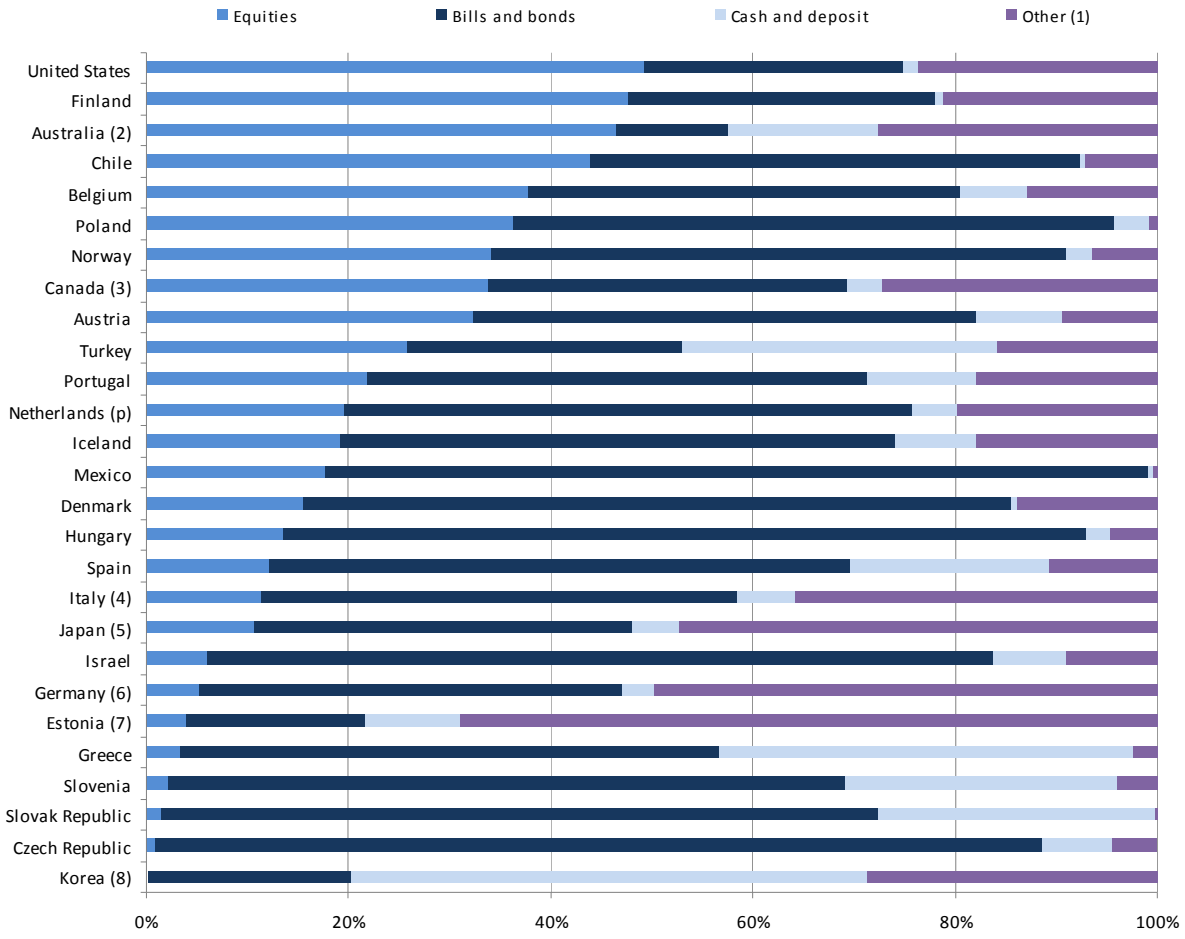
The impact of an FTT on pension funds will depend on both the asset allocation (portfolio) and on the investment strategy (more frequent trading vs. less frequent trading, for example). If one looks at the asset allocation in selected pension funds (see figure 1), **not all these assets represent taxable financial instruments as defined in the proposal**, neither do all the transactions. As an illustration, cash and deposits and other assets (including derivatives, but also investment in real estate and others) make up for 22% (or almost EUR 190bn) in the Netherlands (over 4% in cash and deposits) and 34% in Bulgaria (over 28% in cash and deposits).

Also, a distinction between defined-benefit schemes (DB) and defined-contribution schemes (DC) looks meaningful, as both will have to hedge different risks differently. According to EIOPA data, loan deposits and other assets have a lower weight in the total portfolio in the case of defined-benefit (DB) schemes, whilst these types of assets are better represented in the total portfolio of defined-contribution (DC) schemes, with around 40% in Spain, Italy, Bulgaria and Latvia.

Figure 1: Pension fund asset allocation for selected investment categories

[6] See OECD(2011) Pension market in focus.

in selected OECD countries, 2010 (% of total investment)



[1]This category includes loans, land and buildings, unallocated insurance contracts, private investment funds, other mutual funds.

Source: OECD (2011) Pension markets in focus

The OECD has observed that although most pension funds have performed positively in 2010, investment returns were lower than in 2009. In the OECD countries that have submitted data, in the 2008-2010 period, the average net returns (i.e. returns on savings minus operating cost) reached 2.6% in real terms (4.4% in nominal terms). It was noted that the **funds with conservative investment portfolios and strategies were still ahead in terms of performance for that period**.

The potential impact of liquidity risk on pension funds underlines the need for a suitable risk management and control framework that takes into consideration various elements. This has become more evident especially during the financial crisis because of contagion and

counterparty risk exposures. To a certain extent, the common view that pension funds are typical long term investors may need revision. **When assessing the investment horizon, careful consideration needs to be given to factors that may shorten the effective horizon of investments**, such as periodic rebalancing transactions, active management, (cash) collateral calls or other unexpected liquidity needs. **Such factors may lead to higher turnover levels and shorter effective holding periods**[7].

However, the higher a fund's portfolio turnover rate in a year, the greater the trading costs payable by the fund during the year. A 2011 study[8] by SCM Private in the UK found that, with a 128% turnover rate for the average portfolio, estimated in 2011 this adds 0.7% of total assets in costs per year to an average UK pension fund. For an average 25 years membership in a pension scheme, this additional cost would translate in a 17.5% loss in the real net return for the scheme member.

2.3 Operating costs

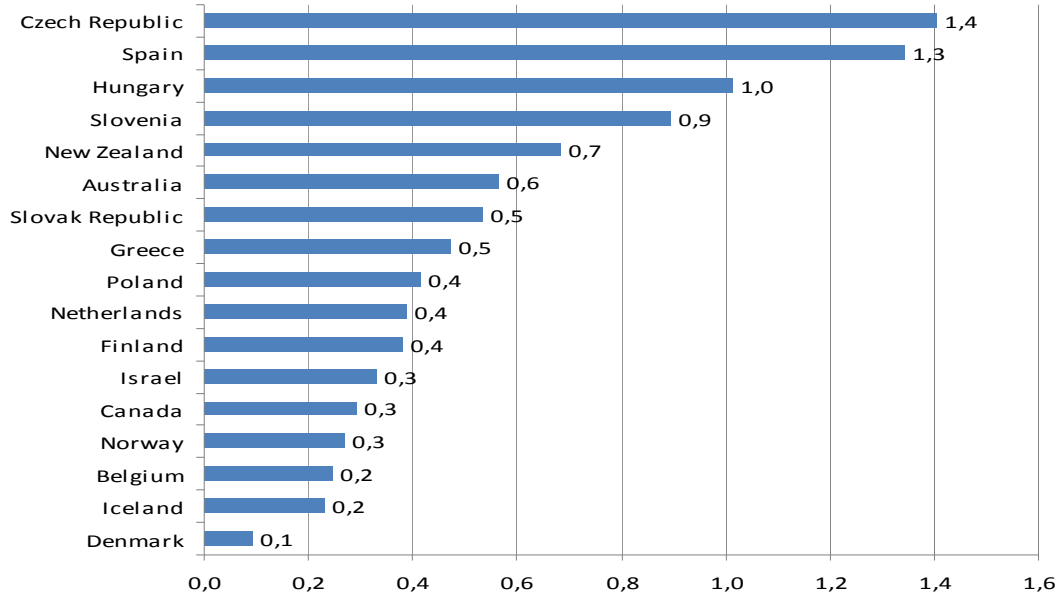
The ratio of total operating costs against assets managed is a measure of the efficiency of private pension systems. The total operating costs include all the costs of administration and investment management; they include costs for marketing the plan, collecting contributions, sending contributions to investment fund managers, record keeping, reporting to scheme members, investing the assets etc. [9]

Figure 2: Operating costs in selected OECD countries (% of total assets)

[7] OECD/IOPS (2011), Good practices on pension funds' use of alternative investment and derivatives, p.29.

[8] Give source

[9] Tapia, W. and Yermo, J. (2008), Fees in individual account pension systems, OECD Working papers.



Source: OECD (2011) Pension markets in focus

The **structure of the fees** that pension funds charge their clients **is quite diverse** and usually covers more of the following at the same time:

- fixed commission;
- fees on contributions;
- fees on assets;
- fees on returns;
- switching/exit fee;
- death and disability insurance.

The magnitude of the fees varies across countries and depends mainly on the concentration in the market (the level of competition between pension funds), but also on the investment strategy. Very actively managed pension funds and investment vehicles come with significantly higher handling fees passed on to the saver than passively managed ones. The operating costs shown in figure 2 relate to total assets and not to annual contributions. If one reflects on the time horizon for which a member is present in a pension scheme, and assuming an average of 25 years[10], the net average return a member will get from its pension scheme could be affected by 35% in case the operating costs amounted to 1.4% of total assets, while they would remain limited to 2.5% in case the operating costs were only 0.1% of total assets.

10 Pitt-Watson, D. (2010) – Tomorrow's investor: Building the consensus for a People's pension in Britain, FRSA, p.17.

2.4 The use of derivatives and alternative investments by pension funds

The recent agreement on the regulation on OTC derivatives (EMIR) contains a clause temporarily exempting pension funds from abiding to the rules on the mandatory use of central clearing. The non-use of central clearing triggers additional posting of cash as collateral (mainly, for the variation margin). Nevertheless, national capital requirements should provide a guarantee similar to cleared contracts. The regulation will also be reviewed in order to see whether high-liquid non-cash assets could be used as collateral.

Derivatives can be used for various purposes by long-term investors such as pension funds – most notably as a substitute for direct investment in the underlying asset (because of liquidity, market timing, tax or other reasons) and risk control. Derivatives can also be used to change the characteristics of their portfolio investments (such as the duration of their fixed income portfolio). They can also be used for risk control or hedging, duration control and general portfolio management. However, **derivatives can also be used for other purposes, including speculation and leveraging of portfolios, which can come into conflict with the basic objectives of a pension fund**[11].

The IORP directive also contains some general rules on investment (in Article 18), including on the use of derivatives: *"investment in derivative instruments shall be possible insofar as they contribute to a reduction of investment risks or facilitate efficient portfolio management. They must be valued on a prudent basis, taking into account the underlying asset, and included in the valuation of the institution's assets. The institution shall also avoid excessive risk exposure to a single counterparty and to other derivative operations."*

Usually, **the use of derivatives is limited in the national legislation**, where ceilings for certain types of assets may be defined (there are no such rules in the IORP directive). In general, the use of derivatives is more spread in pension funds operating in Member States such as the UK, Netherlands or Sweden, compared to those from Member States in CEE.

a) Qualitative limits

[11] OECD/IOPS (2011), Good practices on pension funds' use of alternative investment and derivatives.

For example, Romania authorizes the use of derivatives only in cases where pension funds have the underlying assets in their portfolio. In Germany, derivative transactions are only permitted if derivatives are used for the purposes of hedging, acquisition preparation and yield-enhancing operations under specific conditions and in a limited way. The use of derivatives in short selling, however, is not permitted. In Slovakia, mandatory funds considered to have the most risky portfolios, that is, investment in overseas securities, must hedge at least 20% of the net asset value of the fund against currency risk, with this limit rising to 50% in a balanced pension fund (zero currency exposure is allowed in conservative funds). There are, sometimes, also countries with specific rules on the use of OTC derivatives; for example, in Germany, Bulgaria and Poland the use of OTC derivatives which involve certain types of charges is restricted.

(b) Quantitative limits

In Germany, for both Pensionsfonds and Pensionskassen, derivative use is limited to 7.5% of the total assets of the portfolio at the last balance sheet date. This limit applies to acquisition-preparation operations and yield-enhancing operations. Yield-enhancing operations occur when the securities actually held in a portfolio are used in order to increase returns via financial derivatives. Generally, acquisition-preparation operations and yield-enhancing operations only use certain derivative instruments which are assigned to this specific purpose and are thus permissible. For hedging operations, the volume of balance sheet items hedged by these instruments may not exceed 100% of the portfolio of assets at the latest balance-sheet date. If derivatives are used for the purpose of a pre-emptive purchase taking place within one year or the purpose of an increase in profit, each instrument has to follow a limit of a maximum 7.5%.

In Austria, the supervisory authority applies minimum standards for risk management, and where a Pensionskasse is assessed as not meeting these requirements, investments in derivatives are restricted to a maximum of 5% of the portfolio. In Estonia, up to 10% of the value of the assets of a pension fund can be invested in derivatives, with the exception of foreign exchange hedging

The use of alternative investments (in hedge funds, private equity, structured products, securitised real estate investments, etc.) has also taken off during the last ten years. In the Netherlands, for example, the use of alternative investments (% of total assets) is around 6.2%

(3.4% in hedge funds and 2.8% in private equity)[12]. With relatively higher returns, alternative investments also tend to be more expensive than traditional investments (compared to UCITS, for example[13]), with fees of 1.5-2% of the assets under management, plus a performance-related fee of 10-20% of the return on investment.

3. The impact of the proposed FTT on pension funds

3.1 Interaction with regulation

The FTT proposal does not primarily aim at dealing with the behavior of financial institutions; this is a rather secondary objective. These are issues best being dealt by regulation, and the Commission considers publishing a proposal to review the so-called IORP directive (2003/41/EC) mainly with respect to capital and solvency requirements, including in the light of the financial and economic crisis developments and of the implementation of the framework directive Solvency II (for the insurance sector).

The management of risk and the increased use of alternative investments and derivatives by pension funds have also come to the attention of supervisory authorities. In the OECD/IOPS paper on 'Good practices on pension funds' use of alternative investments and derivatives it was noted: *"Though suffering less of a direct impact from the financial crisis in general and from such instruments in particular than other financial sectors, pension fund regulators and supervisors raised concerns that the pension funds which they oversee did not understand the products they were investing in, or have the necessary risk management systems to cope with them."*

The Commission has already issued in 2011 a Green paper – 'Towards adequate, sustainable and safe European pension systems' – which highlights that *"increasing reliance on private schemes has fiscal costs, given the widespread practice of providing tax incentives during the*

[12] IOPS (2011), Pension funds use of alternative investments and derivatives - regulation, industry practice and implementation issues, p. 18.
[13] Nevertheless, also for UCITS, in the case of use of funds of funds (pooling amounts together) there are extra-fees.

accumulation phase. The costs of tax relief can be considerable and its effectiveness and redistributive impacts questionable"[14].

However, the approach taken by the FTT directive is without prejudice to the discussions around striking the right balance between the need for sustainable social security systems achieving adequate pensions and social inclusion objectives and the need for structural reforms, including of the pensions systems, especially in the light of attaining a fair and inter-generationally sustainable way of funding these systems.

3.2 Impact on transaction costs

One could now argue that the introduction of an FTT would affect (private) pension funds involved in more frequent trading much more than those that trade less frequently in financial instruments, i.e. those funds pursuing a "buy and hold" strategy would be much less affected than those following an "active" strategy with significant and frequent turning over of assets. This difference is illustrated in the below box.

"Buy and hold" versus "active management" strategies

Example 1:

A Dutch pension fund has invested its assets of EUR 10 bn the following way: 10% in shares, 10% in real-estate funds, 70% in bills and bonds, and 10% in other (such as cash or deposits or real estate). The Fund follows a passive "buy and hold" strategy, i.e. it shadows the relevant indices for shares, it purchases bills and bonds when they are issued and holds them until maturity. Pay-outs (to pensioners) and pay-ins (from contributors) are balanced. Due to changes in the composition of the stock-market indices, it has to turn over (buy and sell) on average 10% of its shares and real-estate funds each year. None of the new purchases are purchases on primary markets.

- Transactions in 80% (primary markets for bills and bonds, cash and deposit and other such as real estate) are out of scope of the FTT directive. The turning over of the shares and real-estate funds carries Dutch FTT.

[14] See also the Social Protection Committee's report "Privately managed funded pension provision and their

- The pension fund has to pay EUR 400.000 Dutch FTT annually for the turning over of its shares in case the Netherlands applied the minimum tax rates. This corresponds to 0.004% of its assets.
- If these assets represented 20 years of savings / asset accumulation the annual figure of 0.004% of total assets translated into 0.08% of annual savings, i.e. a pensioner who has invested EUR 100/month would receive returns (after FTT) as if he had invested only EUR 99.92/month in case the fund managers passed these costs on fully to the pensioners and not to the borrowers of capital.

Example 2:

Same asset structure etc. as in the previous case, but this time the pension fund follows an "active" strategy, and turns over all its assets except cash and deposits and other (such as real estate), i.e. 90% twice a year. It does not intervene on primary markets for bonds and bills and shares. Also, as it is more exposed to market volatility, it is assumed to hedge 90% of all its assets four times a year against diverse risks.

- The turning over of assets carries Dutch FTT, so do the hedging operations;
- The pension fund has to pay EUR 36 mn Dutch FTT annually for the turning over of its assets. Annual Dutch FTT for hedging 3.6 mn. This corresponds to 0.396% of its assets.
- If these assets represented 20 years of savings / asset accumulation the annual figure of 0.396% of total assets translated into 7.92 % of annual savings, i.e. a pensioner who has invested EUR 100/month would receive returns (after FTT) as if he had invested only EUR 92.08/month in case the fund managers passed these costs on fully to the pensioners and not to the borrowers of capital.

As these latter would also have to cover the market risk of falling bond prices on a permanent basis, their derivatives activities might also be more important by several orders of magnitude. This impact could possibly be partly offset due to the potentially positive effect a FTT would have on volatility which would benefit the longer term investment strategy of pension funds (because of higher predictability). Evidence in the economic literature on this effect on volatility is however mixed.

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contribution to adequate and sustainable pensions" published by DG EMPL in 2008.

Also, the investment strategy with respect to the portfolio structure could have an impact on the effects of the FTT on pension funds, as e.g. investing in government bonds and bills on primary markets would not be a taxable transaction, while buying and selling shares on secondary markets or investing in derivatives such as structured products would be taxable events.

Asking for an exemption (or special treatment) under the FTT directive for pension funds would undermine the level-playing field between various products available for savings and retirement. Moreover, pension funds (both public and private) enjoy a favorable tax treatment in numerous Member States. Despite the specifics of pension funds, there are equivalent products available on the markets, such as various types of bonds, collective investment funds and life insurance contracts (unit-linked insurance plans). While insurance premia are taxed in some Member States according to national law, bonds and collective investment funds are covered by the FTT proposal, and the insurance and reinsurance undertakings trading in financial instruments are also included in the scope.

TECHNICAL FICHE[1]
RELOCATION, SUBSTITUTION AND OTHER MARKET REACTIONS

The application of an indirect tax bears the intrinsic risk of agents "relocating" their activities to reduce the fiscal burden. "Relocation" might take place by (i) moving the relevant activities to jurisdictions where they are taxed less, (ii) by shifting to products/suppliers outside the scope of taxation within the same jurisdiction e.g. by changing the business model or contract design, or (iii) abandoning the taxable activity altogether. In principle, this latter might even lead some products/markets to disappear in the medium and longer run. Obviously, the risk of physical relocation of markets/market players and migration to non-taxed products decreases the more widespread is the adoption of the taxes and the broader their scope. Thus, the concrete design of a tax in combination with the transaction costs of relocation will largely impact on the actual extent of relocation. The cases of Sweden and the UK, which both introduced a tax on financial transactions with different relocation effects, provide some evidence for this.

The responsiveness of traded volumes to taxes (and transaction costs in general) varies across products and markets, as it is heavily influenced by available substitution possibilities and the characteristics of the relevant trading platforms. Thus, the design of the tax will be as important as its rate or change in the rate.

The risks of geographical relocation, as well as those arising from potential migration towards untaxed substitute products, could be minimised by (i) not taxing certain activities at all, by (ii) extending the geographical coverage of the tax and by (iii) including a wide range of financial products and markets (exchange and over-the-counter) in its scope. It can also be reduced by linking the FTT with some form of registration. Clearly, coordination in terms of products covered by the tax as well as of applicable tax rates is a prerequisite for lowering the incentives to relocation across jurisdictions.

1. GEOGRAPHICAL RELOCATION

So as to effectively avoid having to pay FTT it would not suffice that a financial institution simply moves its seat outside the EU. This is, because for as long as a financial institution intends to either undertake transactions in the EU or to serve a European client base it would

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be deemed to be established in the territory of a Member State (Article 3.1 of the FTT proposal). Thus, a financial institution would have to both abandon to trade on European trading platforms (this would also hold for the remote access to European trading platforms from outside Europe) and to abandon all its European clients if it wanted to avoid paying the tax.

European client base

Example1:

An American bank sells a derivative via a Swedish retail bank to a Swedish local authority. The Swedish retail bank acts for the account of the local authority.

- FTT is due twice in Sweden at the Swedish rate as both banks are deemed to be established in Sweden.
- If the notional value of this derivative was EUR 10 mn. and Sweden applied the minimum rate of 0.01% each financial institution would have to pay EUR 1.000.

Example 2:

A German bank asks its American-based Investment Bank subsidiary (AS) to hedge a currency risk in its name. For this, the American subsidiary (AS) enters into a derivative agreement in the name of the German bank with another American bank (AB) having no link to the territory of a Member State.

- FTT is due twice in Germany at the German rate as the German bank is established in that Member State and the second American bank (AB) is equally deemed to be established in that State (Article 3.1).
- If the notional value of this derivative agreement was EUR 10 mn. and Germany applied the minimum rate of 0.01% the German bank itself and the American bank would each have to pay EUR 1.000. The American subsidiary would not have to pay FTT as it was acting in the name of the German parent company.

This very broadly defined residence principle distinguishes the actual design of the FTT as proposed by the Commission from the design typically analysed in studies preceding the Commission proposal, and highlighting the relocation risk in case an FTT was introduced at a sub-global level.

Also, certain transactions most prone for geographical relocation, i.e. those not involving an EU party at all, fall outside the scope of the proposed tax[2]. Thus, there would be no incentive

[2] Art. 1.2 reads: "*This transaction shall apply to all financial transactions, on condition that at least one party to the transaction is established in a Member State …*"

to relocate the so-called "booking centre" services.

"Booking centre" services

Example:

A Spanish bank concludes in the name and for the account of an Argentinean pension fund an interest-rate swap with a Portuguese bank that acts in the name and for the account of a Brazilian pension fund. Neither the Argentinean nor the Brazilian pension fund is deemed to be established in a Member State. The swap agreement runs over five years and its notional value is EUR 10 mn.

- This transaction is out of scope of the directive (Art. 1.2) as none of the parties to the transaction (neither the Argentinean nor the Brazilian pension fund) is (deemed to be) established in a Member State.

Thus, the risk of geographical relocation remains rather limited. So do the benefits of relocation.

2. SUBSTITUTION AND CHANGING BUSINESS MODELS

The Commission proposal is characterised by a very broad definition of transactions, instruments and institutions, as defined in Article 2 of the proposal. This approach to cover all markets (regulated and over-the-counter), all actors (from traditional banks via the so-called "shadow-banking sector" to big non-financial companies that undertake significant financial transactions) and all products (from shares and bonds to derivatives and structured products) was inspired by the invariable strive of market participants to minimize their tax burden and engage in economic activities that are either not taxed or less taxed. By the same token, it was also inspired by the need for preserving "tax neutrality" and not to discriminate against or to privilege certain actors, markets or products.

A significant share of the market reactions triggered by the introduction of this tax is assumed to be the result of actors replacing taxable events with (new) un-taxed business models. For example, the traditional way of brokering (where brokers buy and sell in the name or on account of other financial institutions) might replace the current practice of trading in ones own name and on ones own account (e.g. by broker/market-makers) as this would relieve them from paying the tax (see Art. 9.2 of the proposal[3]). In the present business model of

[3] Art. 9.2 reads: "Where a financial institution acts in the name or for the account of another financial institution only that other financial institution shall be liable to pay FTT."

transaction chains being dominated by proprietary trading by all actors, each transaction would show up (in the statistics of market turnover) as a buying and selling transaction, i.e. a single purchase/sale operation triggered from outside the financial sector might (statistically) show up as two, three or even four trades at each side of the transaction. Once such proprietary trading will turn into taxable events the trading might be replaced by "intermediation". So, while "trading" turnovers will decline, the initiating underlying economic substance (one actor wants to buy and one other wants to sell) remains unchanged, and the potential cascading effect of the tax within a single transaction chain can be avoided.

Brokerage and market making services

Example 1:

A Belgian and a French private household use respectively their Belgian and French retail banks and order them to buy/sell on the Paris stock exchange, in the name or for the account of the respective households, shares of a French joint-stock company in the value of EUR 10.000. The retail banks pass on these orders to their wholesale banks and those to their brokers on the Paris stock exchange. All three intermediate only, without buying or selling for their own account.

- Both retail banks are liable to pay the FTT due in their country of establishment (Belgium and France respectively) (Art. 9.1). Neither the wholesale banks nor the brokers are liable to pay FTT (Art. 9.2).
- The retail banks would have to pay EUR 10 each for this transaction in France and Belgium respectively. The effective tax rate for the whole transaction is 0.2%.

Example 2:

Same case as in example 1, but, this time, the shares are passed on through five successive sales and purchase: Apart from the two retail banks, who act in the name or for the account of the respective households, all other participants act in their own name and for their own account as well.

- All six financial institutions are liable to pay FTT in France and in Belgium respectively. Both brokers and both wholesale banks have to pay FTT twice, while the retail banks have to pay only once.
- The brokers and wholesale banks would each have to pay EUR 20 and the retail banks each EUR 10. The effective tax rate for the whole transaction is 1.0%.

An alternative to the provision of Article 9.2 would have been to exempt professional dealers from the scope of the tax in first place. However, this would then also have put out of scope those trades between financial institutions that are not a rent-seeking complement to

intermediation but also those that are genuine trades between financial institutions. This, in turn, could have significant negative revenue implications as well.

Closely related to avoiding cascading effects in a transaction chain by going for intermediation instead of proprietary trading, is a substitution effect where untaxed business models are used in general. For example, bonds (the trading of which would be taxed) could be replaced by untaxed loans, or RePo agreements (where bonds are sold and repurchased) could be replaced by economically similar transactions where such bonds were only serving as collateral for outright lending and borrowing of central bank money.

Repurchase agreements

Example 1:

A bank established in France lends "over-night" EUR 10 mn. to a bank in Italy (possibly backed up by securities as collateral).

- No FTT is due as outright lending and borrowing is out of scope of the FTT.

Example 2:

A bank established in France buys "over-night" EUR 10 mn. of French government bonds from a bank established in Italy and sells them back the next day (repo transaction):

- FTT is due both in France and in Italy for each transaction (Art. 2.1).
- As the market price of the transaction is EUR 10 mn., and as there are two transactions, each bank has to pay EUR 20.000 FTT in their country of establishment if both countries applied the minimum rate.

Example 3:

A bank established in France lends shares (with a market value of EUR 10 mn.) of an Italian listed-stock company to a bank in Italy. In accordance with the agreement, the shares are returned to the lender after three months. The lending fee is EUR 10.000..

- FTT is due both in France and Italy (Art. 2.1).
- As the market value of the shares is EUR 10 mn., both the French and the Italian bank would have to pay EUR 10.000 FTT in case both France and Italy applied the minimum tax rate.

It is assumed that financial institutions will not ignore the tax when developing and implementing their business strategies.

The main reason for the assumed decrease in derivatives turnover is that the notional value is the tax base for the taxation of the derivative, mainly for reasons of administrative ease and cash-flow considerations. However, the notional value does not always reflect the economic value of a derivative contract. A tax levied on the notional value looks to target a very large tax base, compared to which the economic value of the transaction appears significantly smaller. Given this large difference it is reasonable to expect that turnover measured in notional values could shrink significantly.

Risk hedging volumes

Example:

A trader exposes himself to a high nominal risk (e.g. EUR 50 mn.) and then hedges the biggest part of this risk accordingly by also taking the opposite risk (e.g. in the order of EUR 40 mn), so that the net risk exposure would effectively be limited to the difference between these two positions (EUR 10 mn. in this case).

- The introduction of a tax on the notional value of the underlying would provide incentives to go for the net risk only, i.e. EUR 10 mn., as this institution would then not have to pay an FTT of EUR 9.000 (for a notional value of EUR 50 mn. + EUR 40 mn.) but only EUR 1.000 (for a notional value of EUR 10 mn.)
- Statistically, the turnover volumes would have declined by almost 90% as the new turnover would only be EUR 10 mn. instead of the previous EUR 90 mn.

Investing in derivatives and investing in the underlying asset are to a certain extent different activities, especially with respect to the leverage effect of the capital invested. It was thus proposed to set the tax rate for derivatives at a tenth of the rate for securities. As a consequence, the tax rate for derivatives renders derivative agreements with a leverage factor of less than ten relatively attractive, i.e. where the capital to be invested will be more than 10% of the notional value of the underlying. By contrast those contracts where this ratio falls below 10% will be less attractive. Thus, derivatives implying a hedging of very small and tiny risks (that means, the premiums to be paid are very small as compared to the notional value) will be discouraged. So will be transactions which are "speculative", i.e. where the actor invested little money so as to gain a lot, but with a small likelihood.

In the economic analysis it is also assumed that the reduction in market volumes is partly the result of the rolling back of certain high frequency but low-margin transactions which would no longer be attractive for the transaction partners once a tax of 0.1% or 0.01% is levied.

Thus, it is assumed that in some market segments the tax will create a structural break in the sense that business models change (e.g. in the field of automated High Frequency Trading) which leads to fewer transactions and potentially other ways of trading assets and risks.

TECHNICAL FICHE[1]
REVENUE ESTIMATIONS

As already stated in the Impact Assessment accompanying the Proposal for a Council Directive on a Common system of financial transaction tax and amending Directive 2008/7/EC (SEC(2011) 1102), at a tax rate of 0.1% for securities and of 0.01% of the notional value for derivatives agreements and payable by each side of a transaction, the revenue estimates for the tax are about €57bn[2].

About one third of this revenue is expected to be generated by taxing trading, borrowing and lending in securities (bonds and shares), and two thirds are expected to come from taxing derivatives.

As can be seen from the table, more than half of all revenue is actually expected to stem from taxing interest rate linked derivatives such as interest-rate swaps.

Revenue estimations (in bn €)

Product	Rate (%, for each tax payer)	
	0.01	0.1
Securities		**19.4**
- shares		6.8
- bonds		12.6
Derivatives	**37.7**	
- equity linked	3.3	
- interest rate linked	29.6	
- currency linked	4.8	

Exempting some of the products from the scope of the tax (such as government bonds or derivatives) would, thus, not only negatively affect the tax neutrality of the proposed approach but also have significant revenue implications. So would have the exemption of certain actors (such as pension funds, UCITS, regional or local authorities or "professional dealers") or certain transactions of actors (such as "market making").

[1] This technical fiche should be considered as a non-paper that commits only the Commission's services involved in its preparation.

[2] One has to keep in mind, however, that estimating revenues for taxes which would be newly introduced and that - to a certain extend – have the goal to change market behaviour and structure bears a high degree of uncertainty.

TECHNICAL FICHE[1]

TAX COLLECTION

Taxing financial transactions is one of the least expensive ways of collecting taxes, as most transactions are carried out electronically and the tax can be collected electronically and at the source. FTT can be collected at very low cost (less than 1% of revenue raised), especially when good use can be made of existing market infrastructures, e.g. with the help of trading platforms, trade repositories or clearing houses. [2]

Nevertheless, concerns have been raised that the tax as proposed would be hard to implement and to enforce as data availability is limited. However, the following sections highlight that the already existing "Markets in Financial Instruments Directive" (MiFID)[3] and the "European Market Infrastructure Regulation" (EMIR)[4] would allow for the payment of the tax to be properly ensured and monitored. These pieces of legislation are to be complemented by the provision for "joint and several liability" as foreseen in Art. 9.3 of the proposal, and that should also encourage voluntary compliance.

1. DATA MAINTENANCE AND PLACE OF KEEPING AT THE DISPOSAL OF DATA

Pursuant to Art. 25(2) of the current Markets in Financial Instruments Directive (MiFID) investment firms and credit institutions are obliged to keep relevant data relating to all transactions in financial instruments (including OTC transactions) which they have carried out, whether on own account or on behalf of a client. In the case of transactions carried out on behalf of a client, the records shall contain all the information required to identify the client and information required to prevent the use of the financial system for money laundering. The data have to be kept at the disposal of the competent (MiFID) authority for at least five years. It is not mentioned where the data is to be kept, but the competent authority referred to should normally be that of the home Member State which authorises the performance of investment services and activities under MiFID. The home Member State as a rule is the State where the head office is situated (natural persons) or in which its registered office (legal persons) is

[1] This technical fiche should be considered as a non-paper that commits only the Commission's services involved in its preparation.

[2] IMF (2011), CPB (2011).

[3] The Directive 2004/39/EC is currently in the process of being reviewed by the co-legislator.

[4] A Council agreement was reached in January 2012; the text is still in the process of first reading by the

situated (Art. 4(20) of the MiFID). Consequently, the information should be easily available in the Member State of authorisation (head office, registered seat).

Some persons, such as (in principle) those only dealing on their own account (unless they are market makers or deal on own account outside a regulated market or an MTF on an organised, frequent and systematic basis)are not subject to the MiFID.

In order to avoid possible lacuna, Article 10(3) of the FTT proposal provides for the (tax) obligation that where financial institutions are not subject to Article 25(2) of the MiFID they shall keep at the disposal of the competent authority, i.e. the tax authority, for at least five years, the relevant data relating to all financial transactions which they have carried out, whether in their own name or in the name of another person, for their own account or for the account of another person. Member States will be required to ensure that financial institutions comply with this obligation. In view of the above it would be logical that this ("tax") information is kept and readily available in the Member State of authorisation of the financial institution (if applicable) or of its head office/registered seat. This applies per separate legal entity.

Financial institutions with a registered seat or head office located outside the EU but with a branch in a Member State of the EU will normally be authorised as a financial institution by that Member State under national regulations. In that case, the above principles remain valid. In case of multiple branches in the EU, different Member States will be involved and data per branch is to be kept in the Member State of the branch.

Financial institutions which do not have any seat or branch in the EU, but are deemed to be established in a Member State of the EU pursuant to Art. 3(1)(e) of the FTT proposal - because of transactions with an EU established party or because they are acting in the name of a party to a transaction with an EU established party - will need to be registered, and keep transaction data at the disposal of the competent tax authorities, in the Member State of establishment of that latter party (cf. Art. 10 of the Commission Proposal).

It is also to be noted that the proposal for a new MiFID will create a harmonised framework for granting access to EU markets for businesses and market operators based in third countries in order to overcome the current fragmentation into national third country regimes and to ensure a level playing field for all financial services actors in the EU territory. Harmonised rules for third country investment firms with or without an EU branch will be provided for.

2. REPORTING OBLIGATIONS UNDER MiFID AND EMIR

Pursuant to Art 25(3) of the current MiFID Member States shall require investment firms which execute transactions in any financial instruments admitted to trading on a regulated market to report details of such transactions to the competent authority as quickly as possible, and no later than the close of the following working day. This obligation applies whether or not such transactions were carried out on a regulated market.

According to Art. 54(5) of the MiFID, that Directive does not prevent competent authorities from exchanging or transmitting, in accordance with national law, confidential information that has not been received from a competent authority of another Member State.

Furthermore, the European Market Infrastructure Regulation (EMIR) proposal COM(2010)484/5[5] stipulates that counterparties (financial and non financial) and central counterparties (CCPs) shall ensure that the details of any (OTC) derivative contract they have concluded and any modification, or termination of the contract is reported to a trade repository. A trade repository shall maintain it for at least ten years following the termination of the relevant contracts and shall make the necessary information available to relevant supervisory authorities, including ESMA. Where a trade repository is not available to record the details of a derivative contract, counterparties and CCPs shall ensure that the details of the derivative contract are reported to ESMA. A CCP shall maintain, for a period of at least ten years following the termination of a contract it has processed, all information on that contract.

The EMIR recitals state that "*For the exchange of information, strict professional secrecy is needed. It is essential, due to the wide impact of OTC derivative contracts, that other relevant authorities, such as tax authorities and energy regulators, have access to information necessary to the exercise of their functions*."

[5] A political agreement was reached in Trilogue for this Proposal. The final text will be approved soon.

It would seem appropriate to provide in national law for access to data held by competent (supervisory) authorities, trade repositories, CCPs, trading venues and ESMA in order for tax authorities to be able to use these data for possible cross checking.

3. ADMINISTRATIVE COOPERATION

For tax monitoring purposes, Member States will have to ensure well-functioning administrative cooperation both at national and European/international level. Data available at one side of the transaction should be provided to the tax authority competent for the monitoring of the tax payment at the other side of the transaction. From an EU and international perspective, the administrative cooperation tools in place will need to be used effectively. To this end, Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC could be used as from the entry into force of the FTT Directive.

In principle, the current scope of Directive 2011/16/EU is broad enough to include FTT, as an FTT is not covered by the exception in Article 2 (2) (i.e. it is not value added tax or an excise duty). This means that apart from the automatic exchange of information, all mechanisms of the Directive would apply to the tax, i.e. exchange of information on request, spontaneous exchange of information; presence in the offices where the administrative authorities of another Member State carry out their duties or presence during administrative enquiries; simultaneous controls. Finally, FTT could also benefit from the sharing of best practices and experience provided by Directive 2011/16.

As regards the automatic exchange of information, the Directive provides for the exchange of available information in respect of a number of defined categories from 1 January 2015 regarding taxable periods as from 1. January 2014. These do not include financial transactions. However, the tax could be included at a later stage in the context of the review of the automatic exchange of information which is due to be submitted before 1 July 2017.

As regards the recovery of the tax, Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures applies since 1 January 2012 and would be applicable to FTT.

The use of the above mentioned EU administrative cooperation tool is outlined in Art. 11(3) of the FTT proposal. From a wider international perspective, the Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters could be applicable to the tax given its very wide scope: it covers exchange of information on request, spontaneous exchange of information (for example in case one State has grounds for supposing a loss of tax in the other State), subject to mutual agreement or consultation: automatic exchange of information, simultaneous tax examinations, tax examinations abroad and finally, assistance in recovery and service of documents. Currently, the Convention applies to Azerbaijan, Belgium, Denmark, Finland, France, Georgia, Iceland, Italy, the Netherlands, Norway, Poland, Slovenia, Spain, Sweden, Ukraine, the United Kingdom and the United States. Some other countries have signed as well, but there is no entry into force yet (Ireland, Korea, Mexico, Moldova, Portugal). A number of additional countries (Argentina, Australia, Brazil, Canada, Germany, Indonesia, Japan, Russia, Turkey and South Africa) have signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters on 3 November 2011 in the margins of the Cannes G20 summit. The Cannes G20 Summit final communiqué mentioned: "*We welcome the commitment made by all of us to sign the Multilateral Convention on Mutual Administrative Assistance in Tax Matters and strongly encourage other jurisdictions to join this Convention. In this context, we will consider exchanging information automatically on a voluntary basis as appropriate and as provided for in the convention.*" Recently, India and Greece signed the Convention.

4. JOINT AND SEVERAL LIABILITY

Where a financial institution which is liable to pay the tax on a transaction does not pay the tax due within the time limits set, each party to the transaction (including persons other than financial institutions) shall become jointly and severally liable for the payment of the tax on that transaction (Art. 9(3) of the proposal). This is not only an additional measure to ensure payment of the FTT, but for commercial reasons it should also encourage the financial institution liable (in the first instance) to pay the amount of the tax due. Member States may also provide that other persons (e.g. advisors) are held jointly and severally liable for the payment of the tax.

5. AUDIT

The implementation of the tax in the Member States will entail certain audit efforts of their tax authorities. First, tax payments will have to be checked against tax returns. Second, the information included in the tax returns will have to be checked against transaction data and cross-checked with other available data as explained before. It is obvious that IT procedures would have to be developed possibly on an EU-wide basis or with knowledge sharing between Member States. The starting point would be to put in place an accurate register of financial institutions established in the territory of a Member State by using the data of supervisory authorities and that on counterparties mentioned in records on transactions. The establishment in the Member States of dedicated tax audit teams which have or acquire financial sector expertise seems to be an appropriate solution.

TECHNICAL FICHE[1]
TAX CONTRIBUTION OF THE FINANCIAL SECTOR

This fiche summarizes the main findings regarding the tax contribution of the financial sector as analyzed in the *Impact Assessment accompanying the Proposal for a Council Directive on a Common system of financial transaction tax and amending Directive 2008/7/EC (SEC(2011) 1102)* as well as in the Staff Working Document on *Financial Sector Taxation* (SEC(2010)1166). The information has been updated where new data were available.

1. Possible economic rents in the Financial Sector likely to increase pay

There is some evidence that the financial sector has been more profitable than the non-financial sector over the last two decades[2]. This is not as such problematic if this above-normal profit is related to higher productivity. However, the high **profitability** of the sector could also result from a lack of competition due to e.g. barriers to entry, the existence of an (implicit or explicit) safety net provided by governments, combined with banking regulation or the VAT exemption (see below). In this case the financial sector could indeed make a more substantial contribution to government finances by the introduction of new taxes which are directed at **economic rents** (profits above normal return) and/ or which take into account the VAT exemption of most financial services. The data used in the Impact assessment on individual companies active in the financial sector suggests however that profitability is very heterogeneous within the sector and depends on the segment of activity as well as on the size of the company measured by total assets.

Potential economic rents can be captured by either the shareholders in the form of higher profits which either increase share prices or are distributed as dividends or by the managers and employees in the form of higher pay (including variable components such as bonuses or stock options). Analysing the **structure of executive compensation** of managers the financial sector (director level), volume 5 of the Impact Assessment shows empirically that there is a significant earnings premium in the financial sector which amounts for the overall sample (including both EU and Non-EU countries) to about 40%. This can be seen as an indication

[1] This technical fiche should be considered as a non-paper that commits only the Commission's services involved in its preparation.

[2] See Devereux et al. (2004) and Lepetit (2010) p. 19.

that possible rents are at least partly translated into higher management salaries in some parts of the financial sector.

2. Except for VAT and bank levies, the tax provisions for the Financial Sector do not differ significantly from those of other sectors

In order to gain a comprehensive overview of existing tax regimes applied to the financial sector, four different tax areas have been analyzed in the Impact Assessment: Corporate Income Tax, Labour Taxation, Value-Added Tax and the taxation of financial instruments. Broadly speaking, looking at 2011 tax provisions, the study does not find any significant differences in the tax treatment of the financial sector compared to other sectors, with the main exception of VAT from which the activities of the financial sector are generally exempted. As a consequence, the sector cannot recover a large part of the VAT paid on its inputs. Instead, the sector may aim at passing this input tax on to its clients. In addition, this section also discusses briefly bank levies.

In **labour taxation**, there are no differences in the treatment of personal income of workers employed in the financial sector. One difference though (albeit temporary for some Member States) is that several Member States have introduced bonus taxes on the financial sector. This would lead to greater taxation in personal income tax. Another point is that in a limited number of countries stock options and bonuses benefit from a favourable tax treatment. This treatment is however available for all sectors. It may be the case that the financial sector has a pay structure more prone to these pay schemes leading to a lower effective tax burden. This was however outside the scope of the study and the correspondents of the contractor did not have the view that this was the case. However, the study on executive compensation in the financial sector in volume 5 of the Impact Assessment finds evidence that the financial sector may rely more heavily on variable compensation compared to some other sectors.[3]

In **Corporate Income Tax (CIT)**, two main differences between financial and non-financial corporations concern the treatment of bad and doubtful loans and the non-application of thin capitalization rules to the financial sector. In the case of bad and doubtful loans, the differential treatment may provide a cash-flow (liquidity) advantage, but not a tax advantage.

[3] Egger, von Ehrlich and Radulescu (2012), "How Much it Pays to Work in the Financial Sector", *CESifo Economic Studies*, 58: 110-139. Computed from Table (1), page 115.

These differences in treatment can however be explained by the structure of the business in the financial sector for which interest received and paid constitute part of the business and not just the financing of activities. In the Member States in which there are these differences, they are explicitly made to take this situation into account. See Table 1 below for an overview of CIT rates as well as related local taxes.

A **bank levy or bank tax** can be interpreted as an additional duty imposed on financial institutions, predominantly banks. Following the recent financial crisis, several countries have taken legislative initiative in this respect, such as an additional levy applicable to banks, which are considered to pose a systemic risk to the economy. Although there are current proposals and negotiations pending in this respect, up to now there is no common approach, for instance between the EU Member States, in relation to such tax. Generally such bank levies are not applied on the income/ accounting result of the bank (as the case for CIT), but are in principle levied on the (relevant) assets, liabilities or capital of the bank. See Table 1 for an overview of current bank levies.

The **taxation of financial instruments** does not seem to lead to specific tax advantages in most countries reviewed, even if in many countries the treatment for accounting and/or tax purposes of financial instruments held by financial institutions differs from its treatment when held by non-financial institutions. However, there is no evidence that this results in an advantage for the financial sector. As regards transaction taxes, only a minority of Member States applies securities transaction taxes, and there is no uniformity with respect to the scope of these taxes. Table 2 below summarizes the information on current transaction taxes.

If statutory provisions of corporate tax systems do not seem to differentiate between the financial sector and the non-financial activities in the EU, the same is not true for Value-Added Taxation (**VAT**). Since the adoption of the Sixth VAT Directive in 1977, the EU's common value added tax system has generally exempted mainstream financial services including insurances and investment funds. Article 135(1) of the VAT Directive provides an exemption from VAT for most financial and insurance services but at the same time, the Directive allows Member States to grant taxable persons the option of taxing financial services. Around ⅔ of all financial services are margin-based which makes the implementation of the invoice-credit VAT system difficult in this respect. The exemption means that the financial sector does not charge VAT on most of its output and that it cannot

deduct the VAT charged on its inputs. This is known as the 'irrecoverable VAT problem' where financial institutions are taxed on their inputs. Based on case studies, PricewaterhouseCoopers (2006) found that VAT recovery rates in the financial sector varied from 0% to 74%. The variations in recovery rates could be explained by differences in the way in which the Member States interpret the scope of the exemption and the option to tax but also by concessional arrangements applicable in individual Member States to institutions operating in the financial sector and by the different weight in different countries of services provided to non-EU customers (see below). An overview of current VAT application can be found in table 3 below. It should be noted that some countries apply for specific insurance services an insurance premium tax. However, products with a savings component (like life insurances) are usually exempted from this tax.

3. Consequences of VAT exemption

The VAT exemption for the financial sector has the likely consequence that, assuming that some input VAT is irrecoverable and passed-through into prices, the price of financial services for business users is higher than what it would be under a VAT system with deductible output VAT, while the price of financial services for final (individual) users is lower than if VAT would be applied. For the latter, this also means that sales from the financial sector are under-taxed compared to sales from non-financial sectors.

The harmonised VAT system aims at relieving exports from VAT burden. For financial services, this is achieved by Article 169(c) of the VAT Directive whereby financial institutions are entitled to deduct input VAT in respect of goods and services used for the purpose of rendering exempt financial services to non-EU customers.

There have been a few attempts in the economic literature to quantify the VAT losses for tax authorities deriving from exemption for financial services and most studies point to a net revenue loss (Genser and Winker, 1997; Huizinga, 2002; De la Feria and Lockwood, 2009). This tax loss on VAT collection from the sector is estimated to be around 0.15 % of GDP (Huizinga, 2002), which for the EU27 translates into close to EUR 18 billion. This order of magnitude was confirmed by the Impact Assessment which, using FISIM data, found a tax loss of about 0.15% GDP.

Some Member States have also tried to simulate the VAT revenue losses from exempting the Financial Sector. The United Kingdom estimates its losses at about GBP 4.5 billion for the fiscal years 2007-2008 and 2008-2009 (about 0.31% GDP in 2008).[4] For Denmark, the estimate was DKK 2.5 billion in 2006 (about 0.15% GDP). [5]

Two Member States specifically use additional taxes to compensate for the VAT exemption. Denmark introduced in 1990 a duty on wage and salary costs (*Lønsumsafgift*[6]) for businesses engaged in certain activities that are exempted from VAT. The tax base is generally the sum of labour costs and taxable profit[7]. For several sectors, including financial activities, the tax base is defined as labour costs plus a supplement of 90%. France introduced in 1968 a payroll tax (*taxe sur les salaires*[8]) which is levied on employers who are not liable for VAT or who have not been liable for VAT on at least 90% of their turnover during the previous year. Those include bank and insurance companies. The tax base is defined as gross remunerations, prior to the deduction of employee's national insurance contribution, including benefits in kind. Those two taxes resemble a Financial Activities Tax.

4. Contribution of the Financial Sector to CIT

In terms of its contribution to corporate tax receipts, the financial sector accounted for a substantial share of such revenues before the crisis. This should not come as a surprise given the weight and the above-average profitability of this sector in general. The EU27 GDP-weighted average share of the contribution by the financial sector to total corporate tax collection was around 20% in both 2006 and 2007. It decreased to 17% in 2008 as a result of the crisis and this share will most probably decrease further in the coming years due to the fact that the accumulated losses during the crisis will reduce future tax payments via loss carry-forward. The values for the EU27 are similar to those for many non-EU G-20 countries, as collected by the IMF for its report to the G-20. For example, between 2006 and 2008, the share of the financial sector in total corporate tax collection was around 18% for the United States, 23.5% for Canada and around 15% in Brazil and Australia.

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4 http://www.hm-treasury.gov.uk/d/pbr08_taxreadyreckoner_287.pdf , page 18.

5 http://www.rigsrevisionen.dk/media(461,1033)/Transparency_of_Tax_Expenditures.pdf , page 29.

6 Covered by the Law on tax o labour costs (lov om afgift af lønsum mv.).

7 In case of losses, these are deducted from the labour costs. The system is therefore symmetric.

8 Covered by articles 231 to 231 bis R and 1679, 1679A and 1679 Bis of the General Tax Code.

5. Contribution of the Financial Sector to sector specific taxes

(a) Payroll Taxes

In the UK, a Bank Payroll Tax was introduced in 2010 in order to tackle the remuneration practices that contributed to excessive risk taking by the banking industry. A Taxable Company (broadly banking groups, banking entities and building societies) operating in the banking sector that awards a bonus greater than £25,000 in value (or bonuses totalling more than £25,000 if more than one is awarded to an individual employee) in respect of employees is charged the bank payroll tax at a rate of 50% on the aggregate of the amounts by which each such bonus exceeds that limit. Given the relative importance of these bonuses in the UK economy, the tax raised a sum corresponding to about 0.24% of GDP (GBP 3.455 billion) in 2010.

(b) Compensatory taxes to VAT exemption, similar to Financial Activities Tax.

In France, the *Taxe sur les Salaires* described above raised EUR 11.354 billion in 2010. This is about 0.59% of GDP. In 2008, about 85% of the amount collected was levied from financial institutions (IMF, 2010).

In Denmark, the *Lønsumsafgift* described above amounted to DKK 5.115 billion in 2010. This is about 0.29% GDP. In 2008, about 70% of this amount was raised from the financial sector (IMF, 2010).

(c) Bank Levies

The receipts of bank levies are in some cases earmarked for resolution or deposits guarantee funds. As such, they are not necessarily recorded as tax receipts. Two examples from Member States give an order of magnitude of the levy revenue. In the UK, where the levy is not earmarked, the bank levy is expected to raise about GBP 2.5 billion per annum. The German bank levy, which is earmarked for a resolution fund, raised about EUR 590 million in 2011.

6. Current legal tax framework in Member States – Overview tables

Table 1: General Tax Regime Applying to Banks: CIT, Local Taxes and Bank Levies

Country (April 2012)	Corporate Income Tax Rate	Local Taxes	Bank Levies	Remarks
AUSTRIA	25% (Annual min. CIT): - EUR 5,452 for banking institutions; - EUR 1,750 for private limited liability companies (non-financial institutions); - EUR 3,500 for public limited liability companies (non-financial institutions).	No	1) Levy to finance the chamber of commerce 2) From 1/1/2011, Bank levy: 2 taxable bases: - Capital assets (based on the unconsolidated balance sheet total). Tax on capital assets calculated on a modified average unconsolidated balance sheet total – tax rate of 0.055%-0.085% depending on certain threshold – allowance if tax base < €1 billion; - Derivatives in the trading book: tax rate of 0.013% based on their nominal value – no allowance for derivatives.	
BELGIUM	33.99%	No	Two levies which apply from 1 January 2012: *Financial Stability Contribution* All banks are subject to financial stability contribution of 0.035%, which is levied on the total amount of liabilities less equity and deposits subject to the guarantee scheme of the Belgian National Bank. *Deposit Protection Fund Contribution* In 2012, a deposit protection contribution of approximately 0.245% will be levied on the amount of deposits subject to the guarantee scheme of the Belgian National Bank. For 2013, the duty will be reduced to approximately 0.15%. For each bank, the exact contribution will be based on a weighted ratio which corresponds with the risk profile of the bank concerned. In addition, the capital adequacy, the quality of its assets and the liquidity will be taken into account.	
BULGARIA	10%	No	No	
CYPRUS	10%	No	Proposed bank levy: legislation is being considered by parliament, to tax deposits excluding inter-bank deposits at a rate of 0.095% (total levy not to exceed 20% of taxable profits).	
CZECH REPUBLIC	19%	No	No	
DENMARK	25%	No	No	Payroll tax (applicable to all entities not subject to VAT), in effect applicable mainly to financial entities, including banks: 10.5% of the payroll total.
ESTONIA	21%	No	No	CIT only upon distribution of profits.

Country (April 2012)	Corporate Income Tax Rate	Local Taxes	Bank Levies	Remarks
FINLAND	24.5%	No	No	
FRANCE	33.33% but a 3.3% 'social tax contribution' may also apply (if CIT exceeds K€ 763), i.e. effective tax rate may be 34.43%	No	Bank levy: financial bill for 2011 created a new 'tax on systemic risks' specific to banks, which will be paid in addition to contributions paid by the financial institutions to the deposit guarantee fund and supervision fees. In a nutshell, a 0.25% tax is assessed on the amount of the bank's equity over EUR 500 million. PEs of foreign banks resident in an EEA country are not subject to this levy.	
GERMANY	15% + 5.5% solidarity surcharge	Yes ('trade tax'), of between 7 and 17.1% depending on the relevant municipal rate (14.35% in Berlin)	- A bank levy (annual levy) is applicable from 1 January 2011 and falls due annually on 30 September. The base for calculating the levy is the sum of: 1) a progressive rate of 0.02 - 0.04% calculated on balance sheet total less liabilities to customers (without liabilities towards affiliate entities) less certain other items (such as funds for general bank risks) and liable equity capital; and 2) 0.00015% of nominal amount of derivatives. The bank levy is limited to a maximum of 15% of net profits plus certain other items and a minimum of 5% of the regular annual contribution.	
GREECE	20% for accounting year 2011	No	Bank debt is subject to a special levy of 0.6% annually on the loan value (L. 128/75).	
HUNGARY	10% up to HUF 500 million tax base, 19% above	Yes (in Budapest: 2%). It is noted that the local business tax base is determined differently from the tax base of the corporate income tax.	Bank levy with start date on 27 September 2010: Progressive rate of 0.15% up to HUF 50 billion and 0.53% on the excess. The levy is calculated on the adjusted balance sheet total (i.e. less, inter-bank lending and loan receivables, etc.). The bank levy is also applicable to other financial institutions (i.e. insurance companies, broker-dealers, etc.), for which different rates may apply.	
IRELAND	12.5% on trading income; 25% on passive income	No	No	
ITALY	27.5%	Regional income tax (introduced in 1997): ▪ 3.9% for non-FS ▪ 4.82% for FS ▪ may vary according to region.	No	
LATVIA	15%	No	Yes, financial stability duty of 0.036% per annum, in force from 1 January 2011, payable by Latvian banks, foreign branches of Latvian banks and Latvian branches of foreign branches	
LITHUANIA	15%	No	No	
LUXEMBOURG	21% + 5% solidarity surcharge = 22.05% from 1/1/2011	Yes, 'municipal business tax': varies between 6.75% and approx. 9%. Banks established in Luxembourg city: total combined CIT/MBT rate = 28.8%	Net wealth tax (computed on net asset value), applicable to all corporations at a rate of 0.5%. No (proposed) bank levies or financial transactions tax.	

Country (April 2012)	Corporate Income Tax Rate	Local Taxes	Bank Levies	Remarks
MALTA	35%	No	No	
NETHERLANDS	25% (with step-up of 20% on first EUR 200,000 of taxable income)	No	No	
POLAND	19%	No	No bank levy or financial activities tax. Currently, a bill to introduce a levy on banks and certain other financial institutions has been proposed by the opposition party in parliament. Given the make-up of parliament, even if the law is ultimately passed, it is unlikely that it will take the form presented in the bill.	
PORTUGAL	25%	1.5% maximum local surtax; National surtax at the rate of 3% is levied on income subject to CIT derived by resident entities and exceeds EUR 1.5 million. Profits higher than EUR 10 million are taxed at a rate of 5%. Reduced rate for Madeira Region but not applicable to banks or FS.	Since 2011, the banking sector is subject to a new contribution regime in addition to the standard tax rates. *Taxable base & tax rates* Base I : Total liabilities less, amongst others: ▪ Items that are accounted for as equity; ▪ Liabilities for defined benefit retirement plans; ▪ Provisions; ▪ Liabilities concerning revaluation of financial derivatives; ▪ Receipts related to deferred income, irrespective liabilities' operations; and ▪ Liabilities related with assets which were not accounted for in securitization's operations. Part of the bank deposit actually covered by the Deposits Guarantee Fund Tax rate foreseen: 0.05% Base II: The notional amount of off-balance sheet financial derivatives, excluding hedging derivatives and back to back derivatives. Tax rate foreseen: 0.00015%	
ROMANIA	16%	No	Proposal of 'solidarity tax' on profits derived by the financial services sector, temporary tax, proposed rate: 2.5% on profits derived during previous fiscal year. As the proposal is still pending in parliament, it will probably not come into effect in the near future.	
SLOVAKIA	19%	No	- No - The Slovak Ministry of Finance has presented its proposal to introduce taxation of banks in 2012. It is not yet clear whether it will be a tax levied on the liabilities of the financial institution or a financial activities-based tax.	
SLOVENIA	20%	No	No	
SPAIN	30%	No surcharges or local direct taxes, but from a CIT/direct taxation perspective, rules differ depending on the territory (for instance special rules applicable to the Vasc region).	No	

Country (April 2012)	Corporate Income Tax Rate	Local Taxes	Bank Levies	Remarks
SWEDEN	26.3%	No	Bank levy effective as from 30 December 2009, for financial years ending after that date: 0.036% of total amount of debt and provisions less intra-group liabilities and other items. This tax rate is halved for financial years 2009 and 2010.	
UK	25%	No	The full rate was 0.075 % from May to December 2011 and is 0.088 % since 2012.The bank levy is applicable to global consolidated balance Sheet liabilities less 'Tier 1', insurance liabilities, protected deposits, sovereign repo liabilities and other items (derivatives on a net basis). For calculation of the taxable base, a threshold of £20 billion is applied.	

Table 2: Securities Transaction Taxes/ Transfer Taxes

Country	Securities transaction taxes applicable in principle	On regulated markets	Type of securities in scope	Provision	Rate	Revenue	Remarks
BELGIUM	Tax on Stock Exchange Transactions	Yes	All securities	Sections 120 *et seq.* of the Belgian Miscellaneous Duties and Taxes Code - "MDTC"	0.17% (or 0.5% or 0.07% depending on the type of security)	EUR 134 million	There is an exemption for non-residents and the Financial Sector acting for its own account
CYPRUS	Levy on transactions effected in respect of securities listed at the Cypriot Stock Exchange	Yes	'Titles', meaning shares, stocks, debentures, founding and other titles of companies that are listed at the Stock Exchange	Law 161 (I)/99	0.15%	EUR 1.4 million	This legislation ceases to be of effect from 31 December 2011
	Stamp Duty	No, exempt if listed at stock exchange	Securities issued by Cypriot-resident companies	Stamp Duty Law L19/1963	0.15% (on the first EUR 170,860) plus 0.2% (on amounts over 170,860)	N/A	Stamp duty is applicable to the agreement and not to the transaction
FINLAND	Transfer tax	No, exempt if traded on a qualifying market	Finnish securities, e.g. equities, PPL, stock options, but not debt securities or derivatives	Transfer Tax Act (29.11.1996/931)	1.6%	N/A	

Country	Securities transaction taxes applicable in principle	On regulated markets	Type of securities in scope	Provision	Rate	Revenue	Remarks
FRANCE	Transfer Tax (not yet in force)	Yes	- Transactions on shares of publicly traded companies established in France, whose capital is over EUR 1 billion - High frequency and automated trading operations, taxable at a rate of 0.01% on the amount of cancelled or modified orders above a ceiling, which will be defined by a Ministerial Decree; and - Purchase of a Credit Default Swap (CDS) by a French Company, taxable at a rate of 0.01% on the amount of contract covered by the CDS.	Amending Finance Law for 2012 (Projet de Loi de Finances rectificative pour 2012, PLFR)	0.1% for shares, 0.01% for HFT and CDS	N/A	N/A
GREECE	Transaction duty	Yes, but also OTC transfers of Greek listed shares are subject to the duty	Greek or foreign listed shares and compound products such as equity swaps, call options, futures	L.2703/1999	0.15%	EUR 54 million in 2010	Draft bill in which amendments are proposed, for example abolition of transaction duty for the sale of listed shares initially acquired after 1.1.2012
IRELAND	Stamp duty		Stocks or marketable securities (including derivatives) of an Irish company or Irish immovable property	Sections 2, 88 and 90 and Schedule 1 of the Stamp Duties Consolidation Act 1999	1% but possibly up to 6%	N/A	

Country	Securities transaction taxes applicable in principle	On regulated markets	Type of securities in scope	Provision	Rate	Revenue	Remarks
ITALY	N/A	N/A	N/A	N/A	N/A	N/A	The Italian Securities Transfer Tax has been repealed for contracts signed on and after 31 December 2007
POLAND	Taxation of sale or exchange of property rights	No, exemption for transactions within an organised market	Securities and derivatives, except Polish treasury bonds etc.	Civil Law Activities Tax Law dated 9 September 2000	1%	N/A	
ROMANIA	Securities transaction taxes	Yes, whether on the regulated market or not	All types of securities	Regulation No. 7/2006 regarding revenues of the National Securities Commission ("NSC"); Emergency Ordinance No. 25/2002 for approval of the NSC Statute; Decision No. 1/2010 for approval of the NSC budget for 2010 (Annex 1)	A commission of a maximum of 0.08% or a monitoring fee of 0.15%; a commission of 0.10 RON when derivatives are involved	EUR 4,022 million in 2009	
UK	Stamp Duty and Stamp Duty Reserve Tax		Equities, certain equity derivatives (cash-settled derivatives excluded) and some loans having equity-like features	Finance Act 1986, Section 87	0.5% (or 1.5%)	N/A	Certain recognised intermediaries (Financial Sector traders) are given an exemption
SINGAPORE	Stamp duty	No, not applicable to transactions on the Singapore Exchange via the scripless settlement system	Stocks and shares, including debt with certain features		0.2%	EUR 1,157 million in 2007	

Country	Securities transaction taxes applicable in principle	On regulated markets	Type of securities in scope	Provision	Rate	Revenue	Remarks
SWITZERLAND	Transfer stamp tax	Yes	Bonds, shares (including shares in investment funds)	Swiss Federal Stamp Duty Act (StG)	0.15% for domestic securities and 0.3% for foreign securities		Foreign banks and securities dealers are exempt parties, amongst others

Table 3: VAT – Option to tax, Payroll taxes, Insurance Premium Tax

Country (April 2011)	Option to tax	Payroll tax (similar to payroll tax base of FAT)	Others
AUSTRIA	Option to tax adopted to a very limited extent, i.e. for certain very specific financial services mentioned in article 135(1)(b) and (c) of Directive 2006/112/EC		
BELGIUM	Option for taxation adopted to a very limited extent, i.e. for certain very specific financial services mentioned in article 135(1)d of Directive 2006/112/EC		
BULGARIA	Option for taxation adopted to a very limited extent, i.e. for certain very specific financial services mentioned in article 135(1)b of Directive 2006/112/EC		
CYPRUS	N/A		
CZECH REPUBLIC	N/A		
DENMARK	N/A	Most VAT exempt activities, including VAT exempt financial activities, are liable to a Special Payroll Tax. Also branches and representative offices are liable if they have employees in Denmark. Financial services companies (or companies whose main activity is financial services) must pay the highest tax rate, namely 10,5 % of the payroll related to VAT exempt activities. The taxable base will as a main rule include all payroll and all taxable benefits	
ESTONIA	Option for taxation adopted for financial services mentioned in article 135(1)(b) to (g) of Directive 2006/112/EC		
FINLAND	N/A		

Country (April 2011)	Option to tax	Payroll tax (similar to payroll tax base of FAT)	Others
FRANCE	The scope of the option is widely defined by a legal provision. However, another provision explicitly excludes from that scope a series of transactions or of kinds of transactions	Not applicable to transactions but paid by a French-established employer on the salaries (progressive in accordance of salary threshold) to the extent that its turnover is either VAT exempt (without credit) or outside scope of VAT In this respect, the Payroll Tax is apportioned on the basis of the following ratio: Numerator: the VAT exempt and the outside scope of VAT revenue, and Denominator: the total revenue (taxable, VAT exempt and outside scope of VAT)	Turnover tax: A 'value added contribution' ('Cotisation sur la valeur ajoutée des entreprises') is assessed on the added value of French companies. This applies to banks and other companies where their turnover exceeds EUR 152,500. The tax is computed by applying a progressive rate ranging between 0% and 1.5% on the added value of the company. Both turnover and the added value are calculated according to special provisions for banks (e.g. 95% of dividends deriving from long-term investments are not taken into account instead of a complete exemption).
GERMANY	Option for taxation adopted for financial services mentioned in article 135(1)(b) to (f) of Directive 2006/112/EC Not applicable for insurance transactions according to article 135(1)(a) of Directive 2006/112/EC and management of special investment funds according to article 135(1)(g) of Directive 2006/112/EC		
GREECE	N/A		
HUNGARY	N/A		
IRELAND	N/A		
ITALY	N/A		
LATVIA	N/A		
LITHUANIA	Option for taxation adopted to a limited extent, i.e. for certain very specific financial services mentioned in article 135(1)(b) to (e) of Directive 2006/112/EC		
LUXEMBOURG	N/A		
MALTA	N/A		
NETHERLANDS	N/A		
POLAND	N/A		
PORTUGAL	N/A		
ROMANIA	N/A		
SLOVAKIA	N/A		
SLOVENIA	N/A		
SPAIN	N/A		
SWEDEN	N/A		
UK	N/A		

TECHNICAL FICHE[1]
THE "RESIDENCE PRINCIPLE" AND THE TERRITORIALITY OF THE TAX

The residence principle as defined in Article 3 is one of the crucial components of the proposal for an FTT with the aim to reduce to an acceptable level the risk of tax avoidance through geographical relocation of transactions outside the EU. Indeed, taking that financial companies are less mobile than financial transactions, taxing institutions that carry trade on the basis of the residence principle mitigates these geographical relocation risks compared to taxing transactions at source or at the place of issuance.

This principle as defined in Article 3.1 (a) to (d) of the proposed directive allows for the trading activities of financial institutions resident in the EU to be taxed, even if such transactions are carried out in third countries' jurisdictions:

Article 3.1:

"For the purposes of this Directive, a financial institution shall be deemed to be established in the territory of a Member State where any of the following conditions is fulfilled:

(a) *it has been authorised by the authorities of that Member State to act as such, in respect of transactions covered by that authorisation;*

(b) *it has its registered seat within that Member State;*

(c) *its permanent address or usual residence is located in that Member State;*

(d) *it has a branch within that Member State, in respect of transactions carried out by that branch;*

(e) *it is party, acting either for its own account or for the account of another person, or is acting in the name of a party to the transaction, to a financial transaction with another financial institution established in that Member State pursuant to points (a), (b), (c) or (d), or with a party established in the territory of that Member State and which is not a financial institution."*

According to this approach, it does not matter where a transaction is carried out but who the transaction partners are. Also, most financial institutions trading in the EU typically need to be authorised and are – in application of Article 3.1 (a) – deemed to be established in the EU.

[1] This technical fiche should be considered as a non-paper that commits only the Commission's services involved in its preparation.

The residence principle can be summarised as follows:

Party/ counterparty	**EU** financial institution (Member State B)	**Non EU** financial institution
EU financial institution (Member State A)	**Tb** / **Ta**	**Ta** / **Ta**
Non EU financial institution	**Tb** / **Tb**	- / -

Legend:
Ta: tax of country A; Tb: tax of country B; Tax paid by EU Party; Tax paid by Non EU party
The taxation rules also apply when an FI is not a direct party but is acting on behalf of a party to the transaction. Where an FI acts in the name or on account of another FI only that other FI shall be liable to pay the tax.

In order to prevent the circumvention of the tax, in essence this rule has been extended to cover those cases in which a EU party (be it financial or non-financial) is trading with a financial counterparty established outside the EU, as described in Article 3.1 (e) of the proposal (see example 2 in the box below). This provision took its inspiration from the VAT directive (Article 58 of Directive 2006/112/EC). The FTT due would then accrue to the Member State in which the European financial institution is deemed to be established (see the two lightly-shaded cells in the above matrix). The only possibility for EU resident entities to avoid the proposed tax is to relocate themselves to third countries completely or through the formation of subsidiaries and in both cases give up their European customer base, a strategy which it is unlikely to be adopted.

The territoriality of the tax (Art. 3.1)

Example 1:
A bank established in Germany carries out a financial transaction with an insurance undertaking established in Spain, e.g. the sale/purchase of shares.

- FTT is due both in Germany and Spain, respectively (Art. 3.1), at national rates.

- If the market price of the transaction was EUR 600.000, and both countries applied the minimum rate of 0.1%, each financial institution would have to pay EUR 600 FTT.

Example 2:
A hedge fund established in France enters into a swap agreement with a bank established in Switzerland.

- FTT is due twice in France at national rate, by the Swiss bank deemed to be established in France (Art. 3.1.e) and by the French bank.
- If the notional value of the swap was EUR 600.000, and France applied the minimum rate of 0.01%, each financial institution would have to pay EUR 60 FTT.

In order to avoid extra-territoriality of the proposed FTT provisions it is also foreseen (see Article 3.3) that a financial institution shall not be considered established in the territory of a Member State "*in case the person liable for payment of FTT proves that there is no link between the economic substance of the transaction and the territory of any Member State*."

The below box illustrates how this provision could be applied.

Economic substance (Art. 3.3)

Example 1:
A Chinese bank and a Chinese investment firm, who acts in the name of a Chinese branch of an industrial company established in Germany, conclude a currency futures contract in China for operations of the industrial company in Germany.

- EU FTT is due at the German rate as both the Chinese bank and the Chinese investment firm are deemed to be established in Germany (Art. 3.1.e).
- If the notional value of the agreement at the time of conclusion of the future contract was EUR 600.000, and Germany applied the minimum rate of 0.01%, both the Chinese bank and the Chinese investment firm would have to pay EUR 60 FTT.

Example 2:
Same case as the first example, but this time it is a commodities (such as steel) futures contract for operations of the German company in China:
In principle, FTT is due as both the Chinese Bank and the Chinese investment firm are deemed to be established in Germany (Art. 3.1.e), unless both Chinese companies can prove that there is no link between the economic substance of the transaction and the territory of Germany (Art. 3.3). Such proof is not available, however, where the operations of the German company in China have an impact on the balance sheet of the German headquarter.

In the debate, some advocated adding the issuance principle to the residence principle as defined in the proposal to better minimise the risks coming from possible avoidance schemes. This approach would allow to tax trading in at least some financial instruments issued in the EU even when Article 3.1.a to 3.1.e do not apply. Where applicable, it would also make taxable cases where two non-EU financial institutions were party to a transaction or were acting in the name of exclusively non-EU parties to the transaction on certain instruments issued in the EU, thus transactions where there was no EU party involved at all. This approach would take its inspiration from the UK Stamp Duty and Stamp Duty Reserve Tax which is solely based on the issuance principle. Taking into account its possible positive impact on fighting tax avoidance, in case the requirement that at least one party to the transaction must be established in a Member States is not fulfilled, this issue might deserve further technical examination.