# NEW TAXES ON THE FINANCIAL SECTOR

## ***EXECUTIVE SUMMARY***


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In order to promote the knowledge and dissemination of recent legislative developments affecting the financial sector's tax issues both on the international level as well as within the scope of the European Union, the study starts with a brief explanation of the initial steps taken by the G-20 up to the Proposal for a Council Directive on a common system of Financial Transaction Tax (Proposal for a FTT Directive), analyzing the fiscal instruments already implemented in various jurisdictions on an unilateral basis which rang from taxes on bank assets or "Bank levies" to Financial Activities Taxes (FAT) and Financial Transactions Taxes (FTT). The study also included some thoughts on these measures within the Spanish context. Additionally, the study analyzes the various relevant tax implications of the Proposal for a FTT Directive from a technical point of view, including a critical evaluation of the economic impact that its implementation could have. Finally, the study comments on the conclusions reached by the UNED professor Mr. José María Labeaga in his analysis of the economic effects of the Proposal for a FTT Directive on the Spanish equity market, which was also requested by Fundación Impuestos y Competitividad to him in order to complement this study.

**Background**

The economic crisis currently affecting the financial system has brought to light the existence of some deficiencies and inadequate incentives in the financial sector. This has rekindled the political debate on the need to reform financial markets, revising not only their regulatory and supervisory aspects, but also developing new tax measures for the sector.

**Initial approach of the International Monetary Fund**

After the request made by the G-20 in its meeting held in September 2009, the International Monetary Fund (IMF) was one of the first agencies to carry out a more in-depth analysis of the alternatives for reforming the financial sector. It issued a report describing the different measures that some countries had implemented to reinstate the government subsidies received by the financial system. It also mentioned other additional measures which the

IMF felt would guarantee that taxpayers would never again have to bear the cost of restoring the health of the banking system, and which at the same time constituted a deterrent to carrying out activities involving the assumption of excessive risk.

Among the measures being discussed in some countries, the IMF analyzed the "*Financial Crisis Responsibility*" proposed by the US government, which would levy a 0.15% tax on financial entities with more than 50,000 million dollars worth of assets weighted in terms of their risk. It also analyzed the instruments implemented by the UK and France to temporarily tax the bonuses paid to bank and financial entities executives that exceeded a certain threshold. In the IMF's opinion, none of the measures studied completely fulfilled the goal of restoring the public funds spent to rescue the financial system. According to the IMF, the measure that best contributed to achieving this aim would be the creation of a retroactive tax applicable to certain elements of financial institutions' balance sheets at the date of publication of its implementation, thus avoiding possible arbitration procedures.

Additionally, as a measure aimed at avoiding that taxpayers would again have to bear the cost of helping the sector, the IMF analyzed the creation of a contribution called "*Financial Stability Contribution*", which would be used to create funds which would intervene financial institutions with problems. These funds would be given adequate legal mechanisms and would guarantee early government action to try to stabilize any weak financial institution, limiting its loss in value and proceeding, if necessary, to wind it up quickly and in an orderly fashion, thus avoiding generalized recapitalizations aimed at maintaining unviable financial entities.

Finally, the IMF also studied other tax measures that could help to increase the amounts collected from the financial sector such as the FTT, which would be levied on all financial transactions carried out in organized markets, or the FAT, which in its broadest version would be similar to a synthetic VAT and in its simplest version would only be levied on the profits and income of financial entities which exceeded a certain threshold.

The IMF's conclusions suggest that, in its opinion, the direct cost of aids to the financial sector should be limited and should be covered by any instrument similar to the "*Financial Stability Contribution*", and that any additional tax measure to be implemented to collect higher amounts from the sector should be done by creating a FAT in its broadest version since, in its opinion, the FTT would not affect the size of financial institutions (considered a key element of the sector's instability) and could easily be transferred to final consumers, thus not helping to achieve the goals set by the G-20.

The IMF's report was discussed by the G-20 in Toronto in June 2010. The political leaders represented there could not agree on the most adequate measures to be implemented. While some of them supported the IMF's suggestions, others considered that instruments like the FTT were more appropriate. In view of the discrepancies that arose between the countries and the impossibility of reaching a worldwide approach, the matter was removed from this international forum and the governments that were represented there were urged to carry out financial reforms and to establish measures of this type on an individual basis.

## The EU's approach

The European Union, which had been working at the same time on these ideas, took over them from the G-20 and started promoting these ideas more intensely at the EU level.

### *Taxes on bank assets ("Bank levies")*

On the one hand, the EU promoted the development of a framework for handling banking crises by drawing up a harmonized set of responsibilities and rules to prevent bankruptcies in the financial sector. These rules were aimed at facilitating the orderly winding up of unviable entities, and the suggestion made was to create ex-ante funds financed with a tax on the sector which would support this function.

No harmonized approach has yet been reached in this regard, resulting in several European countries setting up their own measures to collect funds to cover the costs derived from the crisis in the sector. Germany, Austria, Belgium, Cyprus, Korea, Slovakia, Slovenia, the

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US, France, the Netherlands, Hungary, Iceland, Portugal, the UK, Romania and Sweden have set up their own mechanism which, based on their main characters, could be included in the category of bank levies.

Although in general terms the aim of all these levies is very similar in all the jurisdictions, in practice their design present differences. The various measures vary with respect to the purpose for which the amounts collected are used, the type of financial institution they are applied to, their deductibility for Corporate Income Tax purposes, and their territorial scope. These differences can give rise to significant issues of double taxation in international financial groups which cannot be solved by the application of the international Double Tax Treaties.

Spain has not incorporated a tax of this type, although someone could question whether the tax on credit entity deposits implemented in certain autonomous communities – Extremadura, Andalusia, and the Canary Islands – could be considered equivalent to a tax on bank assets. Considering the description of the taxable event of these regional taxes, exclusively based on bank financing by means of deposits, in our opinion, they cannot be considered similar to the taxes on bank assets existing in other jurisdictions. In fact, although the definition of the taxable base of these international bank levies varies substantially, they share a common element which is the exclusion of the tax base of any financing by means of bank deposits.

The Deposit Guarantee Fund is another instrument existing in Spain which could be considered similar to bank levies regulated in other European countries. The contributions to be made to it by the financial entities could, in principle, be understood to constitute a "*Financial Stability Contribution*". However, this theory is weakened by the fact that it has existed as part of the deposit guarantee system since the mid-90's and by the recent character given to it by Royal Decree Law 24/2012. Finally, the fact that most of the countries which have established bank levies also have a deposit guarantee system in their internal legislation is an additional argument to refuse such interpretation.

*Financial Transaction Tax and Financial Activity Tax*

On the other hand, it has also been studied the possibility of introducing additional taxes on the financial sector at European level similar to those analyzed by the IMF, that is, the FTT and the FAT.

By implementing these instruments levying additional taxation on the sector, the Commission was trying to complement the regulatory measures aimed at avoiding future crises while at the same time discouraging certain financial transactions which, in their view, are not productive and introduce a high degree of risk in the sector. It also pursued to avoid fragmentation of the internal market given the growing number of unilateral measures that various countries had begun to promote, and to assure conditions of equality of the financial sector with other sectors of activity from a tax perspective. This last goal is based on the perception of under-taxation which the Commission feels the financial sector is subject to due to the VAT exemptions applicable to it. In this respect, the matter is quite controversial and various studies have concluded that although the VAT exemption for financial services may serve as a stimulus for the performance of this activity, in turn these entities cannot deduct all of the VAT borne, so there is no evidence of the existence of under-taxation.

Based on these goals, the Commission studied the advantages and disadvantages of each of these two measures, considering their impact on the cost of financial services, capital flows and investments. In March 2011 the European Parliament finally opted for an EU-wide implementation of an FTT. After carrying out a public consultation process on the sector's tax system, specific consultations to Members States, experts and operators in the sector, in September 2011 the European Commission presented a proposal for a Directive on the Financial Transaction Tax.

**Proposal for a Directive on a Financial Transaction Tax**

This matter has been intensely debated in a number of political forums and meetings during the latter part of 2011 and the beginning of 2012. Likewise, the Member States have been expressing their opinion on the measure, taking a position. As could be expected, due to the high number of operations executed by the UK as European financial center, it was one of the first countries to oppose the measure, even expressly vetoing it. However, other countries such as Sweden, Cyprus, Bulgaria or Malta also seconded this position and declared their opposition to the measure. Simultaneously during this period, the procedural steps required for its approval were taking place, and in May 2012, the European Parliament issued a resolution requiring improvements in the design and proposing some amendments. Among them it should be highlighted the addition of the issuance principle to the Proposal's residence criteria and the exemption from FTT for pension funds.

In the second half of 2012, it became evident that it would be impossible to go forward with this measure by means of an EU Directive since, in view of the express opposition of the aforementioned countries, it would be impossible to obtain the unanimous vote of the 27 Member States required for its approval.

As a result, the implementation of the measure has been rerouted through an alternative channel established in the Treaties of the European Union which would not require a unanimous vote, the enhanced cooperation procedure. Among other requirements, the support of at least nine EU countries is required to develop a specific measure using this procedure. This level of support has been reached since Germany and France, the main promoters of the measure, have been joined by other countries such as Austria, Belgium, Slovenia, Slovakia, Spain, Estonia, Greece, Italy and Portugal, which have sent the corresponding letter of adhesion to the Commission. After obtaining the required minimum level of support and verifying compliance with the other requirements, in October 2012 the European Council approved its proposal authorizing interested countries to go ahead with the measure through the enhanced cooperation procedure. This proposal was ratified by the

European Parliament on 12 December 2012, so it can be foreseen that the procedure will finally be approved by the ECOFIN Council at the beginning of 2013.

The use of the enhanced cooperation procedure to approve the FTT raises certain doubts. The nature of the tax should not substantially differ from the Proposal for the Directive initially approved by the Commission, since there could otherwise be obstacles to its approval. Nonetheless, the line drawn by the FTT unilaterally implemented by France (along with Germany, one of the main promoters of the measure) and the content of the initiatives in some countries like Italy and perhaps Spain seem to point to the type of FTT that will probably be approved at the European level.

In this connection, the scope of the French FTT model is narrower than that of the Proposal for a FTT Directive, and only establishes a 0.2% tax rate applicable to the transfer of shares of French financial entities which exceed a certain market capitalization rate (specifically, 1,000 million euros) and a 0.01% tax rate applicable to high-frequency transactions on share and CDR derivatives on treasury debt issued by EU countries.

The Proposal for a Directive on an FTT prepared by the Commission establishes a minimum 0.1% tax rate for sale-purchases and other operations in which the associated risk is transferred (repos, loans of securities, etc.), of a wide range of financial instruments (shares, bonds, notes, money market instruments, participations in Collective Investment Institutions and Pension Funds, structured products, etc) carried out on all kinds of markets (regulated and OTC), as well as the subscription or modification of derivative contracts, in this case subject to a minimum 0.01% rate, and the transfer of financial instruments between entities of the same group. The taxable base is the price paid by the parties, with the exception of derivatives for which the base is the notional amount. The FTT defined in the Proposal for a Directive will only be applicable when at least one of the parties to the transaction is established in an EU Member State and a financial entity established in the European Union in accordance with the criteria established in the Directive is involved in the transaction, either on its own or in a third party's account. Accordingly, the territorial scope of application of the FTT rests on the principle of residence. That is, to the extent that a financial entity can be considered resident in accordance with the criteria established in the Directive, it will be subject to FTT, regardless of where the operation is carried out. Nonetheless, it should be pointed out that the Proposal for a Directive is not limited to regulating the criteria of establishment in a strict sense. Rather, it goes further, and regulates certain cases in which the residence of non-EU financial institutions is attracted to European territory, provided that they operate with and/or for European entities. By regulating this closure clause as well as the broad definition of the transactions and financial instruments to which the tax is applicable, the Commission's aim was to minimize the risk of agents modifying their activities in order to avoid the FTT by relocating the operations and replacing the products with others not subject to taxation. Nonetheless, in an effort to avoid the ultra territorial application of the FTT, the Proposal also includes an escape clause for non-EU financial entities, so that as long as they can prove that there is no connection between the economic reality of the transaction and the territory of the Member State to which their residence would be attracted, they will not be considered established there in relation with this transaction for FTT purposes.

Regarding the definition of financial entity for FTT purposes, to the extent possible the Proposal for a Directive uses the definitions contained in EU regulations; we should point out the inclusion of Pension Funds for these purposes. Nevertheless, the taxation of Pension Funds has been questioned by an amendment introduced by the European Parliament (although it is not binding) according to which Pension Funds would be exempt from FTT until the impact of implementing the tax is reviewed.

Another relevant aspect – as opposed to the French model – is that the Proposal for a Directive defines the FTT in such a way that both parties to the transaction would be subject to it; that is, there would be a taxable event (and taxation) for the seller and another for the purchaser.

Since the FTT is payable by the financial entity, a system of joint and several responsibility is established for the parties taking part in each transaction. This is aimed at encouraging the voluntary compliance of the financial entities as they would be exposed to the commercial risk of having responsibility shifted to their clients if they do not pay the tax within the established deadline.

According to the Proposal for a Directive, the measure has to be enacted on 1 January 2014. However, in view of the course taken by the procedure, the date of effective enactment is currently unknown.

**Unilateral measures implemented by some countries**

Meanwhile, as mentioned above, countries like France have gone ahead with this matter and have regulated their own national FTT. Portugal and Italy are developing unilateral measures along the same line as France, and Spain has considered a draft proposal of a national FTT too. Even before this measure has been pushed forward on the European level, there were other countries that had a Financial Transaction Tax, understood as any tax aimed at subjecting to taxation the negotiation of financial instruments such as shares, bonds and derivatives, the same as is established in the Proposal for a Directive but with a more limited scope. This is the case of Belgium, Cyprus, Finland, Greece, Ireland, Poland and the UK.

Setting up an FTT through the enhanced cooperation procedure implies that those countries which have their own national tax and which join the procedure will have to abolish their internal measures and adopt the measure finally approved by such procedure.

Regarding the FAT, countries such as Denmark, France, Greece, Ireland, Italy, Portugal and the UK have implemented a tax of this kind, in most cases based on a tax applicable to remunerations paid in excess of a specific threshold. We should point out that the implementation of this tax has been truly marginal and interim, so it does not seem to be a sufficiently robust tax policy instrument nor has it been proved reliable at achieving the goals sought.

**Evaluation of the Proposal for an FTT Directive**

One of the main reasons of the various Member States for instating an EU FTT would be to increase their own national resources by decreasing their contributions to the EU budget, as has been suggested by the European Parliament. However, to the extent that the FTT will not finally be applied to the whole EU but only to the Member States that decide to join the enhanced cooperation procedure, it seems that the measure will not serve this purpose. Nonetheless, it seems reasonable to assume that, in any case, the funds the countries collect thanks to the EU FTT will increase their national resources.

On the other hand, the reasons that advise against its introduction should not be disregarded. In the first place, one of the disadvantages of its implementation is that many of the goals sought with the measure could be challenged if we analyze the potential collateral damage that could be caused to the European economy in general. The goals on which its development was based form a long and heterogeneous list framing a sort of universal remedy or instrument to achieve ends as diverse as obtaining market efficiency, controlling the behavior of the agents, collecting taxes, stimulating growth and employment and encouraging the fight against climate change. In our opinion, drawing up such an ambitious and diverse list can contribute to the failure to achieve the goals and a certain lack of consistency among them.

Far from imposing an additional burden on the financial sector, this measure would transfer its effects to the final consumer through higher costs of capital, lower returns on investments or higher commissions for the execution of transactions. Likewise, it is questionable that market efficiency could be improved with this measure, since its implementation would not necessarily imply a reduction in activities with an excessive assumption of risk nor those which imply a high level of leverage. The FTT defined in the Proposal for a Directive seems to be designed to have the most impact on high-frequency activities, often understood to be a source of excess volatility and price bubbles and, therefore, of market destabilization. Well, the extent to which the frequency of negotiation is related to the introduction of risk in financial stability has not been demonstrated. On the contrary, it could be counter-productive as it would favour the use of highly complex and opaque structured products in order to avoid paying the tax. In this respect, it should be noted that the risks traditionally associated with financial markets are being tackled through the implementation of regulatory measures which are better suited to achieving these goals.

In addition, despite the efforts in designing the FTT so as to minimize the effects of relocation and substitution, the agents will tend to move their operations to territories not subject to the tax or toward other products which are not levied. A clear example of this are stock transactions in which, due to the mechanics of execution, based on an ownership model, an undesirable cascade effect could be produced in transactions in which there is a high number of intermediaries. To avoid the cascade effect, the model can be foreseen to evolve to one in which the intermediary does not acquire title to the securities involved in the transaction.

Special attention should also be paid to the negative effect that the measure could have on pension and investment funds. In fact, the FTT would first be levied on the participant upon acquiring the participation; but it would also be levied on the fund for each investment made and for hedging its investment risks. This leads to the conclusion that the FTT penalizes active prudent management through the hedging of market risks and long-term management linked to social welfare, as it implies a reduction in the level of activity of these vehicles, which will seek to minimize the negative effect on their profitability due to the application of the tax. The negative impact will be correlative for the issuing companies and governments in which these funds normally make their investments. The consequences could be magnified by the existence of other products not subject to the FTT (e.g. investment funds not domiciled in the EU, bank deposits or certain savings insurance policies).

The restrictions on access to credit are also among the adverse effects implied by the measure since the banking sector will be heading toward a change in its investment policies, reducing its holding of the less liquid assets and maintaining higher levels of liquidity. With this change in investment policies banks will avoid subscribing repos (which are subject to the tax), also triggering a decrease in the availability for financing on capital markets to companies and governments.

Another relevant effect of introducing the FTT could be the decreasing profitability of non-financial companies due to more expensive hedging of the risks related to their business activities. In turn, the application of the FTT to intergroup operations will penalize the centralization and efficient management of risk in groups of companies.

Without a doubt, the potential adverse effect of introducing the FTT that would have the most important impact on the economy would be the reduction of the Gross Domestic Product (GDP). The Commission itself, in its economic impact analysis, recognizes that the measure could have a negative impact of 0.53% on the EU's GDP. However, independent studies carried out by some consultants (OXERA, among others) suggest that the Commission's calculations are based on certain questionable assumptions which are unlikely to occur, ignoring at the same time some relevant elements. According to these studies, the GDP is more likely to be reduced by around 2.42% if the figures are adjusted to more realistic scenarios.

This additional reduction of the GDP would also have negative consequences on the expected level of tax collection. Thus, the Commission's estimations regarding tax collection figures should also be adjusted along these lines.

In the Spanish context, a recent analysis promoted by Fundación Impuestos y Competitividad on the impact of establishing an FTT like that of the Proposal for a Directive in the Spanish equities market carried out by the UNED professor Mr. José María Labeaga and aimed at complementing this study is particularly interesting. The empirical study shows that the introduction of the FTT would have negative impact on trading levels, which could be reduced by as much as 30%-50% in the long run. Likewise, it points out that the introduction of the FTT could have a negative impact on the GDP and the level of activity, which is in line with the Commission's own comments in its impact analysis. The econometric study establishes that, considering the reduction in trading levels but without considering the secondary effects derived from the decrease in the GDP and employment, the FTT collection in Spain for the Spanish equities market would range between 1,191 and 1,167 million euros. The study concludes that these amounts could not be enough to compensate for the loss in collection of other taxes as a result of the decrease in activity and employment.

In short, the impact of establishing an FTT similar to that defined in the Proposal for a Directive (on the Spanish equities market) can be summarized in the following table:

| | Short term | Long term |
|---|---|---|
| Loss of business volume | 3%-8% | 30%-50% |
| Expected tax collection figures (M €) | 1.191,09 | 1.167,26 |

In conclusion, based on the European studies done by various independent consultants as well as the study done on the Spanish market previously mentioned, it seems likely that, although initially the measure represents an additional source of income, it could be inadequate due to its negative impact and economic inefficiency, as the costs may exceed the benefits derived from introducing it. We therefore believe it would be strongly advisable that the Spanish government carries out an in-depth study of the economic impact that the introduction of the FTT would have in Spain before adopting any specific measures along these lines.

December 2012