



EUROPEAN COMMISSION

Brussels, 28.9.2011
SEC(2011) 1102 final

Vol. 8

COMMISSION STAFF WORKING PAPER

IMPACT ASSESSMENT

Accompanying the document

Proposal for a Council Directive

on a common system of financial transaction tax and amending Directive 2008/7/EC

{COM(2011) 594 final}

{SEC(2011) 1103 final}

ANNEX 7

POLICY OPTIONS

1. POLICY OPTION 1: FINANCIAL TRANSACTION TAX

Box (1). Key terms and concepts

Algorithmic trading: Automated transactions where a computer algorithm decides the order-submission strategy. See also: High-frequency trading. (King and Rime (2010))

Capital Duty: A levy based on the issuance of capital, e.g. the emission of new shares or bonds in the primary market.

Currency Transaction Tax (CTT): A tax that is levied on the gross transaction volume of currency transactions in spot markets as well as in future and derivatives markets involving currency transactions.

High-frequency trading (HFT): An algorithmic trading strategy that profits from incremental price movements with frequent, small trades executed in milliseconds for investment horizons of typically less than one day. See also: Algorithmic trading. (King and Rime (2010))

Financial transaction: In its broadest sense, a financial transaction can be defined as any (contractual) transfer of financial assets or as any payment of money (cash or transfer) between a buyer and a seller attached to the (contractual) transfer of a right with an economic value. In principle the transferred right can be a non-financial good or service as well as financial assets and instruments like equities, bonds, derivative contracts, structured products, repos or currencies. For the purpose of transaction taxes, financial transactions refer in the context of this document to transfers of financial assets and instruments only.

Financial Transaction Tax (FTT): In this document a financial transaction tax is defined as a tax which consists of two elements, namely a CTT and an STT.

Market liquidity: A characteristic of the market where transactions have a limited impact on prices (“price impact”) and can be completed quickly (“immediacy”). (King and Rime (2010))

Securities Transaction Tax (STT): A tax that is levied on the gross transaction volume of primary and secondary market transactions with equity securities, debt securities and alike products (e.g. certificates, warrants, units in funds, structured notes etc.) and related (including commodities) derivative products including options, swaps, futures and forwards traded in exchanges and over-the-counter (OTC). STT can also be levied on a subset of these financial instruments.

1.1. Scope of application: Taxable event and place of taxation

This section discusses the basic concepts and prerequisites for an implementation of a financial transaction tax as a general framework to assess the impacts of this policy option. The general concepts outlined below are not related to the precise scope of the tax (CTT, STT

or FTT) but touch upon general implementation requirements. Some of the aspects raised here are also discussed in IMF (2010b).

1.1.1. Primary vs. secondary market financial transactions

The first question that arises when designing a tax on financial transactions is whether this tax should be imposed on both primary and secondary market (financial) transactions or only on one of them. Primary market transactions relate to the issuance of the financial instruments, whereas secondary market transactions refer to the subsequent transfers of those instruments.

One possibility would be to levy the FTT only on secondary markets. The argument for this approach is that a transactions tax is targeting trading activity, but not the process of capital-raising by companies and governments. This is also the basic principle of the Capital Duty Directive (Directive 2008/7/EC). The tax neutrality of restructuring operations is a principle embedded in both the Capital Duty Directive (for indirect taxation/capital duty) and, for direct taxation, the EU Merger Directive (Directive 90/434/EEC). It is derived from the need to remove obstacles to the freedom of establishment and to encourage company cross-border mobility. Also, restructuring operations referred to in the Capital Duty Directive cannot be subject to any form of indirect tax according to the current legislation.

On the other hand, it is obvious and there is theoretical and empirical evidence (see also Annex 12) that the tax burden of a transaction tax will *ceteris paribus* depend on the trading frequency of the issued instrument. If only secondary market transactions are taxed, companies' bonds and equities and governments bonds will depreciate (i.e. the cost of capital will increase) depending on how often they are traded. If the tax was only applied to the primary market, this unequal treatment of instruments would be reduced since every instrument would face the same cost at issuance, but its tax burden would not depend on the trading frequency afterwards.

Some derivatives and especially almost all Over-the-Counter (OTC) derivatives are not traded at all.¹ They are bilateral contracts between two parties with no secondary market as for example also loan agreements. If a tax is levied only on secondary markets, these instruments would remain largely untaxed. If there was the objective to tax transactions in these products a tax on primary markets – to be more precise on the contracting of the derivative – would need to be considered. To the degree that they are not used to raise capital, their taxation would however be possible under the Capital Duty Directive.

Thus, from an economic point of view, in order to avoid further distortions, the alternative to tax both, primary (contracting) as well as secondary market financial transactions might have less disadvantages than taxing only primary or secondary market transactions.

¹ Note that trading in bond markets has indeed decreased since it has been partly substituted by the use derivatives. If a market agent wants to transform interest payments received from a bond or hedge the default risk from a debt security he does not necessarily sell the bonds and purchase assets with the desired interest flow or risk profile but rather keeps the bonds and buys for example interest rate swaps or credit default obligations.

Since the taxation of capital issuance infringes the Council Directive 2008/7/EC of 12 February 2008 concerning indirect taxes on the raising of capital (Capital Duty Directive) a first legal step necessary for the implementation would therefore be the change of the Directive. Additional changes would need to be introduced with regard to restructuring activities of companies. The Directive states that restructuring operations cannot be subject to any form of indirect tax whatsoever. In order to solve this, an exemption for restructuring transactions could be foreseen.

1.1.2. Taxable event

For all definitions below, the basic concept of the taxable event of a transactions tax is the transfer of ownership of a financial instrument or the registration of a contract in case of OTC derivatives. Hence, the taxable event is defined as the exchange of the instrument and the legal transfer of the property right with all connected rights and duties connected to the ownership. In cases where no exchange of instruments takes place, the taxable event is when the contract is concluded while the chargeable event is at the point where the legal obligations occur. For derivatives the taxable event is accordingly the moment when the contract is agreed upon.

1.1.3. Place of taxation and taxpayer

In order to define the financial transactions that each jurisdiction would be entitled to tax under the FTT, different principles could be used. More particularly, the right to tax could be defined by reference to (a) the tax residence of the parties involved in the financial transaction; (b) the place where the financial transaction is deemed to have taken place; or (c) the place of issuance of the financial instrument being traded. In theory, a tax could potentially employ more than one of the connecting factors at the same time outlined above (thereby extending the potential tax base), as long as double taxation is avoided. A more detailed explanation of each of these principles is provided below.

Within these three principles, the taxpayer could be further distinguished to allow for an application of the tax on certain traders only.

Box (2). Proprietary trading

The tax could potentially be limited to two factors – (i) transactions involving proprietary trading by (ii) financial institutions. Proprietary trading (mainly by investment banks and hedge funds) has been subject to considerable criticism and is assumed to pose significant risks for single institutions, specific markets and consequently for the financial system as a whole. Those concerns are also behind the reasoning for the "Volcker Rule" proposed in the United States that aims to limit the trading that banks do with their own money.

The differentiation between proprietary and non-proprietary trading is however only possible if the regulatory environment is providing the means to clearly identify these transactions and to share the relevant information with tax authorities. The information on proprietary trading would be most accessible at the level of the financial institution, which would normally keep separate track (even separate desks) of proprietary and client trading. The drive of financial regulation towards increased transparency of financial markets could allow that information to be at the disposal of financial markets as well. In that respect, any definitions of proprietary trading for tax and regulatory purposes may need to be broadly aligned.

Proprietary trading in its broad definition can take the form of directional calls (i.e. betting on the market trend), price/risk arbitrage, market-making, hedging, etc. The risk associated and the market impact of those activities may differ significantly.

(a) The FTT based on the Tax Residence Principle

(i) Member States' taxing rights

Under a FTT based on the tax residence of the parties involved in the financial transaction, each jurisdiction would be entitled to impose FTT on every financial transaction conducted by individuals and entities that are considered as residents in this jurisdiction, regardless of where the financial transaction is deemed to have taken place. Under this principle, the market participant would therefore be liable to tax for all his or her global financial transactions in her jurisdiction of residence. The correct determination of the tax residence of market participants must in this case be clearly defined in order to avoid double or non-taxation. This points to the well-known problem of determining the place of tax residence of taxpayers in an international context.

In order to apply this principle it would be necessary to clearly identify the legally relevant buyer and seller of every financial transaction – the persons or companies which actually exchange the property rights and receive the economic benefit from the trade. The tax would be levied on one or both parties involved in the financial transaction, depending on whether they are resident for tax purposes in a jurisdiction applying the tax. If one leg of the trade is a non-resident buyer/ seller, he would accordingly not be taxed. If both parties are resident for tax purposes in jurisdictions levying the FTT, the FTT would be a two-legged tax levied at half the total rate for each leg.

The FTT based on the *Tax Resident Principle* would thus allow the state of tax residence to tax all the financial transactions entered into by its tax residents, regardless of where the trade takes place. By contrast, tax residents from countries without such FTT would not be taxed.

A strict application of this system could mean that investors from countries that do not levy the tax would be tax free and this would create a tax wedge: Non-EU investors might have a higher incentive to invest in a European company/ government bond than domestic residents. In addition, exchange of information with third countries might be necessary².

(ii) Tax collection issues

While this principle has advantages, notably that the tax revenue would be distributed according to the financial trading conducted by tax residents, the enforcement and compliance costs must be addressed for mainly three reasons:

a. EU intermediaries

Firstly, the cost of collecting the FTT might be very high. The collection would be possible only if, either every tax resident (private households, companies, government agencies) reports to the tax authorities the financial transactions in which they enter; or, administratively easier and less costly, if financial intermediaries like banks, brokers, funds, exchanges etc. are considered as the collecting agents of the tax.

If the financial intermediary involved in financial transactions effected by residents in jurisdictions where the tax applies is from an EU Member State, it should be in charge of collecting the FTT. There are, however, practical issues with applying that approach. In the first place, intermediaries may not necessarily be in a position to determine correctly the tax residence of their client and to assign the tax revenues to the appropriate Member State. In addition, for some derivatives, as outlined in 5.2.2.2., there may be no consideration (i.e. payment) at the time of contracting, and therefore, no monetary flow from which the tax could be withheld/ collected.

A tax only on proprietary trading of financial institutions would arguably not be as challenging from tax collection point of view, because financial institutions would keep better track of their investments and their economic substance than retail investors.

b. Non-EU intermediaries

If an intermediary in a non-taxing jurisdiction is used, the tax resident is liable to tax. For OTC markets, the tax would be collected when contracts are registered with an official regulatory body (central clearing platforms, trade repositories or other bodies) and only if one of the contracting parties is a domestic tax resident. This would require a high degree of international cooperation on exchange of information with countries where the intermediaries. In addition, the administrative costs for the tax authorities for tracking transactions carried on a global basis may be excessive.

² Such systems do already exist. An example is the EU Savings Directive (2003/48/EC).

c. Non-EU financial markets

In order to impose the FTT on transactions conducted by residents in jurisdictions where no tax is applied, the national tax administration may need to receive the information on the details of the transaction taking place abroad not only by non-resident intermediaries, but also by the non-resident financial markets too. This would also require not only a high degree of international cooperation on exchange of information, but also a degree of transparency (and development of that degree of transparency over time) of those non-EU OTC markets that is equivalent to the one in the EU.

d. Relocation

In terms of relocation it should be noted that there is the possibility that a company moves its trading activities to subsidiaries or other related entities in a third non-taxing country and repatriates profits from trading via dividends (which would be exempt either under the non-taxing country's domestic law or under its double taxation agreements), or via transfer pricing arrangements.

Financial transactions carried out on exchanges or where central counterparties are interposed in order to reduce counterparty risk and increase transparency often involve a number of parties and intermediaries. One transaction may be broken down into a series of transactions first between the initiating party and the broker/ dealer who further deals with a member of a clearing house (exchange) and who in turn deals with the central counterparty (CCP)/ clearing house (exchange). The other side of the transaction may be divided in the same number of transactions. In this case for each transaction in the market would need a (cross-border) look-through approach in order to identify the legally relevant agents. A solution to that may be the assignment of withholding/collecting and reporting duties to the intermediary that is immediately acting for the originator of the transaction.

The Anti-Money laundering regulations could be helpful tools to deal with this problem. The advantage of the look-through approach is that buyer and seller could be identified and their nationality or the country of residence for taxation could be disclosed. This would be necessary if revenues are to be shared among the governments involved.

(b) The FTT based on the Source principle

Under a FTT based on the *Source Principle*, each Member State would have the right to tax all the financial transactions that are deemed to have taken place in its jurisdiction, regardless of the tax residence of the parties involved in the transaction. The Swedish transaction tax experience can be seen as a tax levied according to this principle. Alternatively, the place of settlement could be defined as the tax location. Note that the place of settlement and the place of transaction do not necessarily coincide. This might have effects on enforcement and revenue distribution.

Designing the FTT in this way would require defining criteria to determine where a financial transaction is deemed to have taken place. For instance, OTC contracts could be taxed in the jurisdiction where the derivative/ trade is registered or settled, regardless of the tax residence

of the parties to the contract. Financial transactions using exchanges or any organised trade platform can be considered to take place in the jurisdiction where these centralised systems are located.

Carefully defining on whom the tax would fall legally and when the tax can be collected is necessary. For instance, it must be defined whether the FTT is to be paid at the moment of notification of the trade or at the moment of settlement of the contract. Equally, the exchange, settlement system, or central information points which would be legally bound to collect the tax must know which person is liable to pay the tax, the buyer, the seller or both. A possibility would be that these central collecting agents debit the buyer and the seller of each transaction with 50% of the tax.

The advantage of designing the FTT under this principle is that no identification of the party instructing the transaction is necessary. The tax could be collected at central clearing platforms or electronic exchanges and other trading platforms thereby avoiding excessive administrative costs.

Nevertheless, there are some other design issues to be considered, namely:

- It would need to be assured that transactions within a business entity are also taxed, to exclude tax avoidance by vertical as well as horizontal integration (conducting transactions within rather than between businesses): The result could be larger financial institutions creating possibly additional systemic risks.
- The fact that a central tax collection system exists would lead to a geographical concentration of the revenue in countries with major trading centres. Given the strong concentration of financial markets in some Member States the distribution of revenue might be very uneven. Systems of revenue-sharing among countries could also be agreed, but not without related data collection for the sharing.
- The risk that the transactions together with the trading platforms are relocated to jurisdictions which do not levy such a tax is very high.

(c) The FTT based on the Domestic Issuance Principle

Under a FTT based on the *Domestic Issuance Principle*, each Member State would have the right to tax the financial transactions involving securities issued by domestic actors, notably shares and bonds by domestic companies, domestic government bonds and derivative contracts settled or contracted in the country.

This principle is similar to the basic idea of the UK stamp duty where enforcement is strengthened by linking evidence of ownership to the proper payment of the duty. The UK stamp duty taxes only shares of UK-registered firms irrelevant where the trade takes place (see also Annex 8). In the UK the regulations permit a paperless transfer of shares to be registered, provided it is made through an electronic system approved by the Treasury under the regulations. The SDRT regulations impose an obligation on the operator of CREST (or

any other Treasury approved electronic transfer system) to collect SDRT on transfers going through its system. The responsibility for paying SDRT rests with the “accountable person” as defined in the SDRT Regulations. This is usually the broker acting for the purchaser of the shares. Where the SDRT is not paid through CREST, the customer is required to send full details of the transaction to the SDRT Office with payment of the SDRT. Once payment is received an official receipt for the payment is issued and any interest on late payment calculated and requested.

1.2. Taxable base

The heterogeneity and rapid evolution of the different financial instruments pose difficulties for the definition of the taxable base of the FTT.

A useful tool to define and track the products covered by the FTT would be a harmonized nomenclature of financial instruments and products in order to guarantee that for tax (and also regulatory) purposes, Member States use equal definitions. A role model could be the Standard International Trade Classification used in the area of customs. All existing financial instruments should be listed in order to make sure that all product definitions are identical in all countries. Without such a tool there is large scope for interpretation with regard to the tax treatment of certain products which could in turn lead to substitution and loopholes.

Nevertheless, it must be borne in mind that employing exhaustive lists would arguably facilitate arbitrage around strict inventory of definitions. Changes to such a list would need to be agreed by Member States.

1.2.1. Spot transactions

The definition of the taxable base for spot transactions should not pose serious problems. There is a large amount of national experience and the value of the asset as priced in the transaction could be taken as the taxable amount. The gross transaction volume would be the tax base.

1.2.2. Derivatives

Defining the FTT base for derivative transactions raises more questions. It has been proposed that the value of the underlying instrument or asset, i.e. the notional value, is used as the taxable base. This value is the nominal or face amount that is used to calculate and record payments on the instrument. This notional value is commonly used in options, futures and currency markets and for a large share of derivatives easier to observe than e.g. prices or premiums which for some products do even not exist.

There is also a more fundamental economic argument for the use of the notional as the tax base. If the FTT were based on the premium, traders are essentially rewarded for using more out-of-the-money options. These products have disproportionately lower premiums due to the higher implicit leverage. For example, if the premium is the tax base traders could switch from an option with the same notional value but a different strike price and reduce the

premium and therefore the tax burden. When using the notional the tax will be invariant to the amount of implicit leverage in the option.

However, the notional value as tax base poses also a number of questions. It is a fictitious reference and may not be taken as the real value of the derivative contract insofar as this underlying asset/instrument is very often not transferred at all. In addition, the link between the value of a derivative and its underlying varies widely among the different types of derivatives, but also within the same type of derivative depending on its terms. Finally, as will be discussed in section 6 using the notional could lead to significant market reactions which have to be taken into account.

Box (3). Derivatives – some background

In financial terms, a *derivative* is a financial instrument - or more simply, a contract whose performance is based on the behaviour of an underlying asset. The price of a derivative is thus derived from one or more underlying assets. It is a financial contract with a value linked to the expected future price movements of the asset it is linked to - such as a share or a currency. Thus, a derivative is an agreement between two parties that is contingent on a future outcome of the underlying.

The underlying could be anything but the most common are commodities, securities, currencies, interest rates, yields, a stock index or other financial measures, transfers of credit risks, climatic variables (i.e. weather), freight rates, emission allowances, inflation rates and economic statistics. The overall derivatives market has five major classes of underlying assets: interest rate derivatives (the largest), foreign exchange derivatives, credit derivatives, equity derivatives and commodity derivatives.

There are many kinds of derivatives, with the most notable being swaps, forwards, futures, and options. Since a derivative can be placed on any sort of security (or indeed behaviour or event), the potential base of derivative contracts is very large. Even derivatives themselves can be used as an underlying asset. Moreover, derivatives can take the form of very complex contracts and are not always based on assets with a direct value to the price of the derivative. For example, weather derivatives are financial instruments that can be used by organisations or individuals as part of a risk management strategy to reduce the risk associated with adverse or unexpected weather conditions. The difference from other derivatives is that the underlying asset (rain/ temperature/ snow) has no direct value to the price of the weather derivative.

Furthermore, compared to bonds and equity, a distinction between primary and secondary market transactions is less relevant, but derivative contracts can also be distinguished by the way they are traded in the market, i.e. over-the-counter (OTC) or exchange (organised markets) traded. OTC or off-exchange trading is to trade financial instruments such as derivatives usually/ traditionally directly between two parties. It is contrasted with exchange trading, which occurs via facilities constructed for the purpose of trading.

Despite these difficulties, to the extent that the notional value would in many cases be the only value which is readily observable in a derivative contract, it would necessarily be the natural starting point for defining the tax base of the FTT, at least for futures, options and forwards, as more fully explained below:

- *Futures/ Forwards:* A **futures** contract is an agreement to buy or sell a financial product or commodity at a reference price (future price or strike price) at a specified

date in the future. Futures are standardized with regard to the quantity and quality and are traded on exchanges. **Forwards** are similar products but contracted over-the-counter (OTC). The tax base for these contracts would be the underlying asset evaluated at the strike price. However, in case these derivative contracts are actually executed, the question arises whether a new taxable event occurs. If that is the case the underlying financial asset would be taxed with FTT (VAT in case of commodities) at that moment at the price stipulated in the contract and double taxation (first taxation is on the derivative contract as such) would occur. As a result any determination of the tax rate applicable to the notional value of derivative should take this into account.

- *Options*: The owner of an **option** has the choice (but not the obligation) to buy or sell a financial product or commodity at a reference price (exercise price) at a specified date in the future; the owner exercises the option if it would be advantageous for him to do so. The underlying evaluated with the reference price (notional value) would be used as the taxable base. For example, one S&P 500 Index futures contract obligates the buyer to 250 units of the S&P 500 Index; if the index is trading at \$1,000 (given price), then the single futures contract is similar to investing \$250,000 (250 x \$1,000). Therefore, \$250,000 is the notional value underlying the futures contract. However, in case the option is exercised the question arises whether a new taxable event occurs. If that is the case, the FTT tax base relating to the transaction of acquiring the underlying financial asset would be the exercise price (normally VAT taxation in case of commodities) and it would be logical to only apply FTT to the premium paid in respect of the option contract as such.
- *Swaps*: Defining the notional value for **swaps** might be more difficult, since easy transformations can decrease their value. For example, interest rate swaps are agreements to exchange, over a period in the future, a series of fixed interest rate payments for a series of variable interest rate payments. The notional value of an interest rate swap could be divided by an arbitrarily large number while the interest payments are multiplied with the same number. The contract would be economically the same but the tax base defined as the notional would be close to zero. In this case a substance over form or some other legislative limits have to be introduced in order to avoid these effects. In the case of a credit default swap (CDS) - which is a swap contract in which the purchaser of protection (the CDS) makes a series of payments to the protection seller and, in exchange, receives a payoff if a credit instrument (typically a bond or loan) defaults the base could be the insured underlying.

The examples above illustrate that the notional value can be used as the taxable base of the FTT in certain financial transactions. However, the notional value is difficult to determine in some other transactions (for instance the weather derivatives mentioned in box (5) credit default swaps or structured products if derivatives are involved). In these cases, other proxies for the tax bases have to be found. In these cases premiums paid for the contract or on the value to be paid in case of the occurrence of the “insured” event could be used.

In any case, the multitude of financial products would need to be filed and catalogued in order to have an internationally agreed tax base for each product category. If the notional is not applicable alternative other values could be considered which can serve as a taxable base.

Box (4). Issues specific to structured products

Structured products are similar to derivatives in the sense that they are market-linked products. There are multitudes of product categories within the category of structured products, allowing different “packaged” investment strategies. For example, a structured security may take the form of a note that provides varying degrees of capital protection (e.g. from 30% to 100%, but also above). Such types of products have become increasingly popular with retail investors. The investment is essentially split into two parts. One part (e.g. 90 of an investment of 100) is invested in a zero-coupon bond that would yield 100 upon maturity of the structured note, while the remaining 10 are used to purchase derivatives (e.g. options and/or swaps) to track a reference security/basket/market. The leverage of those derivatives allows significant (contingent) returns on the note, combined with capital protection.

A simple approach in taxing structured products of the type outlined above would be to tax the investment of 100. Nevertheless, such an approach would omit the nature of the embedded derivatives and the potential leveraged profits associated. It would also pose an issue of lack of consistent treatment of self-standing and embedded derivatives.

Normally, accounting rules would have to “pierce the veil” of the structuring by applying a “bifurcation” approach, reporting the embedded derivatives separately. Such an approach may be applicable for corporate investors that apply accounting rules, but does not appear practical with regard to individual retail investors.

The above example is provided for illustration purposes only. In other cases the embedded derivatives may not be that easily identifiable or measurable.

1.3. Exemptions

Financial intermediaries: clearing members, clearing house, brokers could be exempted for reasons of tax neutrality and to preserve liquidity in the market. This would however reduce taxable volumes significantly.

In addition, hedging activities through derivatives may be seen as disadvantaged from the levying of a FTT based on the underlying. Although there may be arguments that a very low tax rate would not have a significant impact, the actual tax paid may be substantial compared to the ‘price’ paid for the hedging (e.g. the premium in case of options). Therefore, an exemption may need to be implemented, e.g. through a refund for hedging activities. The use of hedge accounting by the contracting party with regard to the specific derivative may be an indication which could potentially be used for the exemption if the FTT is based on the Tax Residence Principle.

A tax levied only on proprietary trading would effectively exempt all non-financial institutions and private investors.

1.4. Types of FTT

The tax principles and tax bases outlined above can be applied to different product scopes. In the recent discussions three transactions taxes have been in the focus and will be the variants of this policy option discussed in this Impact Assessment.

1.4.1. Option 1A: Currency Transaction Tax (CTT)

A tax on currency transactions is based on the initial idea for a transaction tax on foreign exchange markets by Tobin (1974, 1978). He argued that the increased mobility of private financial capital - especially after the end of the Bretton Woods system - might lead to excessive shifts of funds that create real economic costs for national governments and economies. Tobin reasoned that the tax could increase the effectiveness of domestic monetary policy. This document uses the name CTT and not the expression 'Tobin Tax' which is sometimes used in the popular debate.³

The basic idea of the CTT is to levy a tax on currency transactions and related instruments (FX forwards and FX swaps) transactions. The collection would take place centrally at currency exchange systems, namely in Real Time Gross Settlement (RTGS). A real-time gross settlement system (RTGS) is a payment system in which processing and settlement take place continuously ('in real time') rather than in batch processing mode. Like this, transactions can be settled with immediate finality. 'Gross settlement' means that each transfer is settled individually rather than on a net basis. In the EU such a system is Target2 (Trans-European Automated Real-time Gross Settlement Express Transfer System), which is operated by the Eurosystem and comprising 26 Member States. For transactions which are tracked in such systems a tax could be levied centrally.

Proposals for such systems have been made by the Report of the Committee of Experts to the Taskforce on International Financial Transactions and Development for the Leading Group of countries (2010), Jetin and Denys (2005) and Spahn (2002). A recent study on revenue estimates based has been published by Schmidt (2008). Compared with other transaction taxes the technical discussions are more advanced for the CTT. In this respect, it should be noted that many proponents and notably the report of the Leading group of countries explicitly favour a global application of the CTT.

Also, note that this option raises legal concerns which would need to be addressed by adapting core elements of the TFEU. See Box (5).

³ Tobin himself argued a few months before his death that his name was misused in the debate on financial transaction taxes. See http://www.econ.yale.edu/news/tobin/jt_01-09-02_ds_misusing-name.htm for an interview with Tobin on this.

Box (5). Legal issues with a CTT

A Currency Transaction Tax, i.e. a levy the taxable event for which is the exchange of currencies, indirectly restricts the underlying transactions, both between Member States of different currencies and between Member States and third countries, by rendering them more costly. This may affect payments for the supply of goods or services (current payments) and investments made, for example, by pension funds (capital movements). Although the levy would not apply to the cross-border flow of money as such, it would, absent similar effects on purely national flows, restrict free movement of capital, within the meaning of Article 63 TFEU. This provision commits not only Member States, but also the Union.

Nothing can justify this restriction, since the cross-border flows affected are not objectively different from purely national flows (or flows within a single currency zone [i.e. the euro area]), nor could any overriding reason relating to the public interest serve as a justification. Even if e.g. raising funds to benefit stability funding were to be considered as an overriding requirement of general interest, that requirement could not explain why transactions involving countries with different currencies would be treated less favourably than those involving only one currency. Furthermore, the tax is considered to be disproportionate as funds could alternatively be raised by other means of budget attribution without affecting a basic freedom of the Treaty and, in any event, because the scope of the tax would be unrelated to the risks to be covered by the tax revenue raised. Even a very low tax rate would constitute an infringement, and it would not be possible to establish a threshold of insignificance.⁴

As regards Council Directive 2008/7/EC, its Article 5 (2) provides that Member States shall not be subject to any form of indirect tax the creation, issue, admission to quotation on a stock exchange, trading with stocks, shares or other securities of the same type, or of the certificates representing such securities. This concerns also loans, including government bonds, raised through the issuance of debentures or other negotiable securities, or any formalities relating thereto. Article 6 (1)(a) of the Directive 2008/7/EC expressly states that “[n]otwithstanding Article 5, Member States may charge duties on the transfer of securities, whether charged at a flat rate or not.”

It would need to be assessed whether these rules of Directive 2008/7/EC would oppose the introduction of currency transaction levy, in which case its introduction would require a corresponding change of the Directive.

1.4.2. Option 1B: STT without derivatives and currency transactions

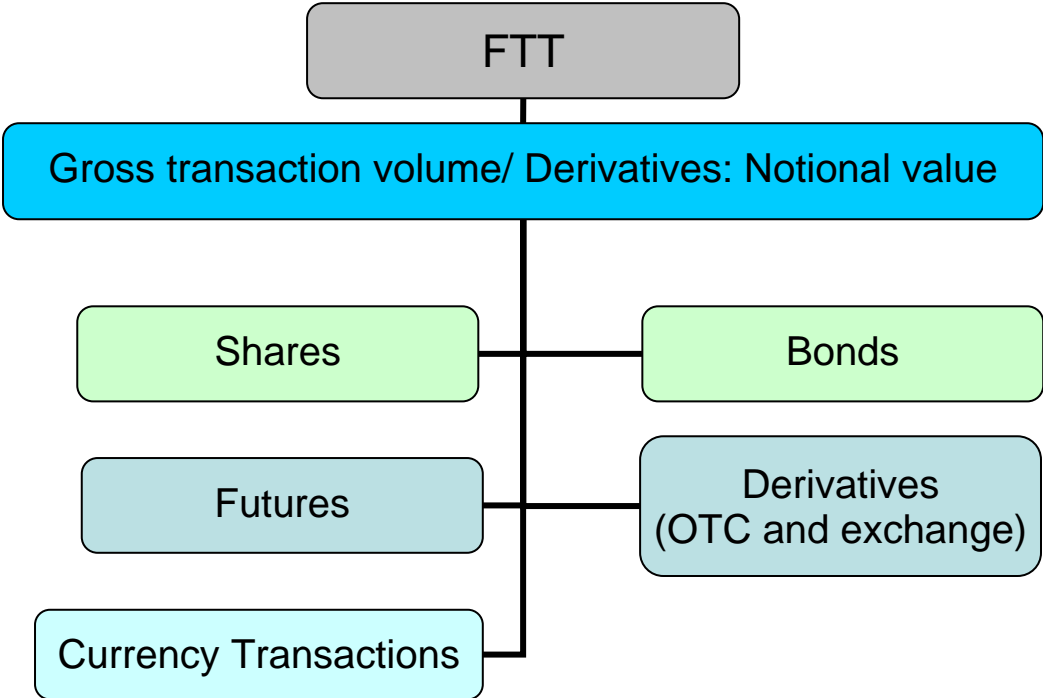
The STT without derivative and currency transactions corresponds to the narrow-based transaction tax described in the SWD on financial sector taxation which would tax only the spot transactions of equities and bonds. It would be levied on all bonds and stock transactions executed in regulated markets thereby making the technical implementation cheap and easy since these systems are operated with centralized economic systems. This option is similar to the UK stamp duty when combined with the domestic issuance principle. Note that for the bond trading product substitution must be considered. It is easy to replace fixed-interest securities with standard bank loans or deposits which are exempt according to the current proposals.

⁴ On free movement of capital and CTL, cf. also Opinion of the ECB on the 4 November 2004 at the request of the Belgian Ministry of Finance on a draft law introducing a tax on exchange operations involving foreign exchange, banknotes and currency (CON/2004/34). http://www.ecb.int/ecb/legal/pdf/en_con_2004_34_f_sign.pdf

1.4.3. Option 1C: FTT

This option would cover all financial transactions as outlined above. In fact, it consists of the STT and the CTT. Since it would cover also OTC markets a full coverage of transactions and access to all transactions data is necessary to effectively be in a position to levy the tax independently of the tax principle chosen. Figure (1) shows the products covered in Option 1C.

Figure (1): Variants of an FTT



1.5. The tax rate

Generally, the level of the rate would depend on factors such as the revenue potential, the level of impact on targeted markets or the importance of the tax rate relative to the transaction costs in specific markets. There is obviously a link between the tax base and the tax rate of the FTT. Thus, if, as illustrated above, the notional value of a derivative contract is taken as the tax base but this value does not reflect the real value of the product at stake, in order to avoid

excessive taxation of such a product, a “lower” tax rate (or a range of “lower” tax rates) is advisable.

With regard to the structure of the tax rate, two options are possible: a flat rate and differentiated rates.

1.5.1. Flat rate

One option is to set a uniform rate for all transactions. This has the merit of being simple and easy to comply with, but it might not sufficiently take into account the specifics of the products traded and the potential impacts on the different markets.

Most recent proposals assume a low statutory tax rate which ranges between 0.01% and 0.1%. An exception is the above mentioned proposal for a CTT by the Committee of Experts to the Taskforce on International Financial Transactions and Development for the Leading Group of countries (2010). They explicitly want to avoid market distortions and suggest a tax rate as low as 0.005%.

By contrast, some Member States have experience in applying stamp duties on equities amounting to 0.5%, and even 1.5% to address tax avoidance. Note that these duties do in general not include derivatives in its scope. However, a tax rate of 0.5% might have much stronger effects if it is applied to notional values in derivatives markets than in equity markets. Thus, a relatively low level of taxation is likely to be essential to avoid strong negative impacts on markets and to ensure some revenue collections, since the incentives for avoidance increase with the tax rate. (See also Annex 10 for a detailed description of the effective tax rates and other economic issues.)

1.5.2. Differentiated rate

A second option is to set differentiated rates, depending on several factors.

- Varying tax rates could be based on the impact of different tax burdens of financial instruments on markets and the (political or economic) desirability of the instrument.
- Tax rates could also be differentiated according to the type of counterparty: banks, other financial institutions (such as hedge funds) for their proprietary trading and non-financial corporations, for example if one makes the assumption that certain of these categories are more prone to speculative trading than others or if reductions in trade volume are different. This information would have to be gathered for all traders in financial markets.
- Another approach might be to look at existing transaction costs and spreads in the various financial market segments. Indeed, these transaction costs will determine the impacts on market liquidity and a transaction tax would clearly be a (new) part of these costs. In markets with high transaction costs (less liquid assets) a single rate is likely to impose a much smaller percentage increase in the transaction costs than where these are low (more liquid assets). In the first case the transaction tax will

have less impact on liquidity. Hence, tax rates might be defined relative to existing transaction costs to avoid large impacts on markets. This would of course imply the exercise of defining the current level of transaction costs for different markets (products) or market segments, both exchange (organised markets) and OTC. An update mechanism relying on unanimity would need to be set.

- Pollin et al. (2002) proposed the following scale of tax rates for a possible Security Transaction Tax (STT) for the US based on the principles of taxing the value of the asset being traded which does not necessarily equal the notional value, and of taking into account the existing transactions costs by adapting the tax rate to the transaction costs level. The proposal takes the 0.5% rate of the UK stamp duty on equities as the benchmark for establishing rates in other markets in a way that minimises distortions:
 - Bonds: 0.01% per each year until bond's maturity.
 - Futures: 0.02% of the notional value of the underlying asset.
 - Options: 0.5% of the premium paid for the option.
 - Interest Rate Swaps: 0.02% per each year until maturity of the swap agreement.⁵
 - Foreign exchange: 0.01% on each spot transaction.

Box (6). Technical aspects dealing with relocation

Although not directly linked to the technical feasibility of a transaction tax, it will be of vital importance for the potential success of any FTT to avoid (or to assess the risk of) relocation of transactions to havens where the tax does not apply - if the tax is not introduced in all countries where major (or to become major) financial centres are located.

First, if Member States decide to tax according to the Residence Principle or the Domestic Issuance Principle, relocation for tax purposes might be pointless in the theoretical case of full and cheap enforcement. In reality, these taxation principles will however raise problems of implementation and of enforceability in the absence of well functioning administrative cooperation and strict reporting obligations to national authorities by domestic intermediaries (source principle) as well as domestic and foreign intermediaries/ tax administrations (residence principle). In case of a unilateral introduction of the tax at EU-level information sharing mechanisms with third countries should be implemented if the residence principle is envisaged.

Second, there are already differences in transaction costs and spreads between countries and the impacts of these and the increase of existing transactions costs due to the introduction of a transaction tax seem to be a determinative factor to assess possible relocations. How far can transaction costs be stretched before relocation occurs? Successful (derivatives) markets enjoy a combination of characteristics and low transactions costs are only one of them. Other factors include ready access to capital, a solid regulatory regime, legal certainty and

⁵ Baker, Pollin, Mc Arthur and Sherman (2009) took 0.01 percent for each year until maturity for the sake of revenue calculations following the pattern with bonds.

political stability, and a large pool of professional talent.

Third, some market places might have a unique position or benefit from “network externalities” which would outweigh the burden of the tax so that it is still an attractive venue for trade. Some researchers refer to the extreme concentration of transactions on exchanges in Europe (only 6% are spot transactions, 94% refer to futures and options) to show that network externalities are well established. However, it can be expected that rivalry amongst the world’s leading financial centres is very intense and market concentration might change quickly. This is particularly important for an application of the tax with limited geographical coverage. If it is considered to tax at EU-level only, it seems indicated to include at least the major financial centres in Europe, i.e. London, Zürich, Frankfurt, Geneva, thus including Switzerland.

1.6. Double taxation issues

As outlined above, States could decide to tax according to the (a) Residence Principle (b) Source and Territoriality Principle (c) Domestic Issuance Principle. In an extreme case all or a mix of these principles may be applied at the same time by the taxing States. In this case the potential for double taxation is obvious if the tax is applied in more than one state. More specifically, if for example a Member State A applies the source principle while another Member State B the domestic issuance principle, double taxation might occur when securities with origin in Member State B are traded in A. On the other hand, if A applied the domestic issuance Principle whereas Member State B would apply the tax resident principle, non-taxation of Member State’s B equity traded by tax residents of Member State A would occur. Therefore it is again necessary that governments which consider the introduction of such taxes co-ordinate in order to avoid double or non-taxation.

The different principles needed to establish the taxation competence of States could be combined in a way that double or non-taxation is minimized to the largest extent possible and that revenue is more equally spread between countries.

2. POLICY OPTION 2: FINANCIAL ACTIVITIES TAX (FAT)

2.1. Rationale

The FAT can best be defined as a “group of taxes”; these taxes share a certain common root but may nevertheless differ considerably. In essence, the FAT would be levied on the sum of profit and remuneration of financial institutions, since one common rationale behind all the forms of FAT is the fact that would a rent occur, it will go either to shareholder in terms of higher profit (dividends or capital gains) or to workers (via higher remuneration). However, as more fully explained below, a FAT can take several possible forms depending on how profit and remunerations are defined and which objectives are pursued with the introduction of the tax.

2.2. The FAT as a direct or indirect tax

Whether the FAT is interpreted as direct or indirect tax has important effects with regard to its potential legal base as well as its integration with other taxes. Broadly speaking, a FAT would

be imposed on value added. This is, similarly to a tax on value added; the FAT would aim at taxing the difference between (i) the proceeds of providing financial services and (ii) purchases of non-labour inputs of financial institutions. This would be equal to the sum of profits and labour costs of said financial institutions. However, the fact that the FAT and the value added tax share the same underlying economic principle and that it is argued that the FAT could serve to address the current VAT exemption of the financial sector, does not necessarily mean that the FAT is an indirect tax.

The classification of the FAT as a direct or indirect tax does not merely belong to an academic debate. As more fully explained below, the definition of the scope of the tax, the methods to avoid double taxation, the interaction between the FAT and other taxes, and even the choice of the legal basis of the TFEU which would eventually allow for a harmonised introduction of the FAT in the EU, depend on whether the FAT is considered a direct or indirect tax. In this respect, there is not a unique definition of what a direct or indirect tax should be, but, rather several criteria which are often used to classify a certain tax as a direct or indirect, as follows:

- whether the taxpayer is or is not the person on whom the economic burden of the tax is expected to fall;
- whether the assessment of the tax takes into account the circumstances of individual taxpayers;
- whether it is a ‘personal’ tax or ‘in rem’ tax;
- whether the tax is levied at regular intervals on sources of income such as employment or property (direct taxes), or on producers in respect of the production, sale, etc. of goods and services, which they charge to the expenses of production (indirect taxes);
- whether the tax is a tax on income (including capital gains and net worth) (direct) or on consumption (indirect).

Under any of these criteria above, the FAT seems closer to a direct tax than to an indirect tax, since (i) there would not be a legal obligation to pass the FAT on to the consumer of financial services on a transaction-per-transaction basis; (ii) the assessment of the FAT would take into account the circumstances of the financial sector; and (iii) the FAT would be periodically levied on all entities that can be classified as financial institutions, on the amount of profits and remuneration that they obtain and pay, respectively, over the relevant period.

Accordingly, even if the FAT could be considered as a ‘hybrid’ tax, sharing features of both direct and indirect taxes (particularly the addition method FAT), for the purposes outlined above, it will be considered as a direct tax.

2.3. Scope of application – the geographical dimension of the FAT

Proposals have been made to design the FAT, particularly the addition method FAT or FAT1, in a way that would essentially mirror the origin/destination principles ruling value added taxation.

Box (7). Design of a tax on the basis of the origin/destination principles ruling value added taxation

1. An origin-based tax

A first option is to design an origin-based tax. This tax would be levied on the profit from domestic production. The base would therefore be the proceeds from domestic and foreign sales minus the cash disbursements on purchasing domestic and imported inputs (including capital goods). An origin-based tax would normally allow for the deduction of labour costs, however, insofar as the FAT would also be imposed on (excessive) remuneration for labour, (at least part of) the labour costs would not be deductible.

2. A full destination-based tax

A second option is to design a full destination-based tax. This tax would be levied only on the profit from domestic sales (i.e. on the profit of sales to domestic consumers both by domestic or foreign companies). The tax base would therefore be the proceeds from domestic sales minus the costs on the inputs (material and capital) used for the production of the goods and services sold domestically. A method of apportionment would determine the overhead costs to be considered in each country. A destination-based tax would normally allow for the deduction of the labour costs that are attributable to the domestic sales, however, insofar as the FAT would also be imposed on (excessive) remuneration for labour, (at least part of) the labour costs would not be deductible.

3. A VAT-type tax

A third option is to design a VAT-type tax. This tax would be levied on the profit from domestic sales (i.e. considering the proceeds of sales to domestic consumers both by domestic or foreign companies). The tax base would be the proceeds from domestic sales minus the costs of domestic purchases. Similar to VAT, export sales would not be taxed but all imports would be. A destination-based tax would normally allow for the deduction of labour costs, however, insofar as the FAT would also be imposed on (excessive) remuneration for labour, (at least part of) the labour costs would not be deductible.

A destination-based FAT

It is argued that a FAT matching the destination basis of value added taxes would best address the VAT exemption of financial services. Under a destination-based FAT, neither borrowing from nor lending to non-residents would be taken into account for the purposes of assessing the FAT payable by a given financial institution.

However, implementing an FAT in such a manner would require that financial institutions keep separate accounting track of domestic and foreign financial transactions. Furthermore, it

would require defining criteria to distinguish domestic and “foreign” financial transactions (by reference to the borrower, the place of establishment, etc). To the extent that the foreign transactions would not be taxed under the destination-based FAT, the risk arises that financial institutions attempt to maximise their “foreign” transactions in order to avoid paying FAT (relocation risks). Finally, it would very likely oblige financial institutions to register for FAT purposes.

An origin-based FAT

Under an origin-based FAT, borrowing from and lending to non-residents would also be taken into account. This origin-based FAT is also sometimes referred to as the source-based FAT. Indeed, to the extent that the FAT can be better classified as a direct tax, which is levied on the institution and not on the transaction, it should be possible to use the concepts of source and residence to define the scope of application of a sort of origin-based FAT.⁶

A residence/ source-based FAT

Designing the scope of application of the FAT on the basis of residence and source principles would have as an advantage that all EU Member States have wide experience on applying these principles in an international setting. The FAT would only be an additional direct tax. At the same time, international direct taxation is far from being a fully harmonised area of taxation, or absent of conflicts. The FAT could be designed to minimise some of these conflicts but, to the extent it is built up on the principles of international taxation principles, it would also certainly share some of them.

A FAT designed in accordance with the residence principle would be levied on the worldwide profits of the financial institutions that are resident for tax purposes in one of the EU Member States. This would mean that the income and expenses of financial transactions with non-residents would also be considered for FAT purposes. A method to avoid double taxation must be envisaged so that the dividends of EU subsidiaries are not subject to FAT in more than one EU Member State (see below).

In order to better proxy an origin-based FAT, the residence-based FAT on EU domestic institutions should be coupled with a source-based taxation of EU branches (i.e. permanent establishments) of non-EU financial institutions. These would be subject to FAT in the EU Member State where they are located.

An origin-based FAT would probably also require that non-EU financial institutions, whose activity in the EU is not intense enough to give rise to a permanent establishment, pay FAT on their financial transactions with EU residents. The best way of applying the FAT in these cases would be a withholding tax. However, withholding FAT on a transaction-per-transaction basis for non-EU residents could conflict with the Double Tax Conventions (DTC)

⁶ It is difficult to identify the residence/source principles of direct taxation with the destination/origin principles; the OECD draws a parallelism between the residence principle and the destination principle; and the source principle and the origin principle, even if it is acknowledged that residence and consumption are not equivalent and that source is associated with income, while origin is associated with production. See OECD (2007) Box 7.1.

following the OECD Model Convention. If the return to the financial transaction made by the non-resident financial institution in the EU is classified as a dividend or an interest, the withholding tax might be allowed under the DTC. By contrast, a withholding tax would likely contravene most DTC if the income earned by the non-EU resident is classified as business income (or even if it is classified as a capital gain, depending on the specific DTC).⁷

2.4. Taxpayer

The FAT would be levied on corporate taxpayers that can be classified as financial institutions. The FAT should be levied on a range of financial institutions as wide as possible in order to avoid that the financing activity shifts to the quasi-financial sector. The financial sector would certainly include banks, credit card companies, insurance companies, consumer finance companies, management fund companies, stock brokerages, investment funds, hedge funds and some government sponsored enterprises, regardless of whether these entities are or not subject to Corporate Income Tax in their respective Member State of residence.

It has been proposed that all the enterprises conducting more than a certain threshold of financial activities become subject to the FAT. Such a threshold could be defined, for instance, in relative turnover terms (turnover of financial activities as compared to the total turnover of the enterprise, or using the VAT pro-rata of the enterprise as benchmark).⁸ Such an approach would allow taxing also intra-group financing and shadow-banking activities.

Referring to the weight of the financial activity as compared to the total business activity could be the only criterion to define the FAT taxpayer or could be used in combination with a list of entities that would in any case be subject to the FAT – those mentioned above.

2.5. Taxable base: the different FAT and methods for calculation of relevant profits

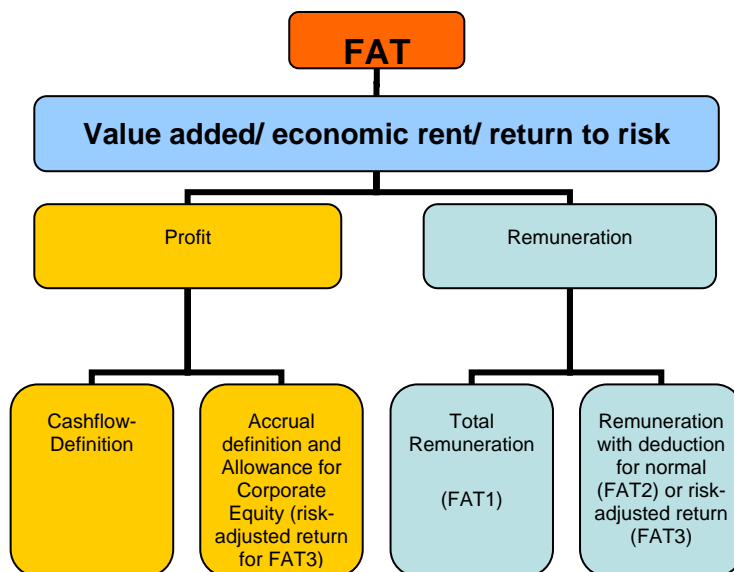
As mentioned, the FAT would be levied on the sum of profit and remuneration for labour of financial institutions. Technically, there are different ways of defining profit and remuneration for FAT purposes. The choice of the method depends on the ultimate objective sought with the introduction of the FAT, namely, taxing value added, taxing economic rents, improving market efficiency and/or discouraging risk-taking activities.

The figure below illustrates how different methods to calculate the taxable base for FAT purposes can be conceived to achieve different FAT, which would in turn pursue different economic objectives.

Figure (2): Variants for a FAT

⁷ Intermediation fees earned by financial institutions can be considered as business income which means that they would normally be exempt from any withholding tax at source pursuant to DTCs. Furthermore, in order to ease the raising of capital by their domestic borrowers, EU Member States have progressively eliminated the withholding taxes on interest, or certain types of interest.

⁸ The classification of the taxpayers depending on their turnover is for instance very often used to identify SMEs (also for direct taxation purposes).



2.5.1. Option 2A: The addition method FAT (FAT1)

The addition-method FAT intends to tax value added of financial institutions. Given the difficulties to determine the value added of financial activities on a transaction-per-transaction basis, the FAT would tax the aggregated value added of all the financial activities undertaken by a given financial institution during a certain period of time.

In order to better achieve this, the profit and remuneration of the financial institutions for FAT1 purposes could be calculated on a cash-flow basis. This cash-flow tax would be effectively levied on economic rents – this is, from an economic point of view, on projects with a positive net present value.

Box (8). Cash-flow taxes

Cash-flow taxes have been the subject of a relatively rich amount of economic literature, starting with the recommendations of the Meade Committee (1978) in the UK (which work is currently being followed-up by the Mirrlees Review).⁹ In its simplest definition, a cash-flow tax at the corporate level would tax corporations on the difference between the sales of goods and services and the purchases of goods and services from other businesses and from employees. This makes two major differences compared to a classical corporate income tax: (i) assets are immediately expensed rather than capitalized and depreciated – or re-evaluation and appreciation of the assets would not be possible either; (ii) sales and purchases are accounted for on a cash-basis and not on an accrual basis (Bradford, 1986).

Cash-flow taxes are typically assessed on the profit resulting from real – in the sense of non-financial – transactions (R). However, the nature of the activities of the financial sector makes it impossible to distinguish the “real” from the financial transactions (F).

A cash-flow FAT would be applied on the so-called R+F base.¹⁰ This would be formed by (i) the sum of cash-in from sales, borrowed funds, interest received and loan repayments, minus (ii) the sum of cash-out from purchases and investments, interest paid, debt repaid and lent funds. Cash in and out from trading with derivatives or any other financial instruments would also be considered. In principle, remuneration for labour is not included as a tax-deductible expense and would consequently be taxed.

Arguably, cash-accounting would lead to lesser differences across EU Member States than accrual accounting. From a practical point of view, there would be two methods to calculate the FAT taxable base in cash-flow terms, considering the available data for accrual accounting:

- Under an indirect method, the FAT taxable base in cash-flow terms could be calculated by adjusting the Profit and Loss Account (P&L) result calculated in accrual accounting (i.e. the profit as used for the calculation of CIT). In essence, such calculation would require deducting from the P&L result the full cost of the investment undertaken by the taxpayer during the year and adding back the depreciation and the remuneration for labour. Remuneration would be broadly defined, it would include wages and salaries, bonuses and other performance-related pay schemes, as well as non-financial advantages (e.g. company cars, company phones, etc). Please refer to section 6.2.2 and to Annex 11 on revenue estimations to find an approximation of the indirect method, which has been used for calculating the revenue potential of the addition method FAT.
- Under a direct method, the profit in cash-flow terms would be calculated as the difference between (i) cash-in from sales and trading of financial products, services and fixed assets plus the increase in borrowing plus interest income minus (ii) cash-out from the purchase and trading of financial products, operating expenses, and investment in fixed assets, plus the repayments of borrowing and interest paid. Wages would not be considered as deductible.

2.5.2. *Option 2B: The rent-taxing FAT (FAT2)*

The FAT can also be designed to tax economic rents only. Such a tax would be designed by taxing profit and remuneration for labour above a defined level. The rent-taxing FAT aims at taxing the rents accruing to the financial sector while leaving untaxed the normal return to capital and labour factors. The taxable base of FAT2 could be calculated in the following ways:

- For the profit part, the normal return to capital can be exempted by using the result of the P&L, adjusted with an Allowance for Corporate Equity (ACE). The Allowance for Corporate Equity or ACE would allow a deduction for a notional return to equity, which would be calculated by reference to the interest rate payable on low-risk debt (government bonds, for instance). Some countries use this method in order to allow a tax deduction that is designed to be roughly similar to the cost of debt-financing. A possibility would be to couple this ACE with a restriction of the deductibility of the

interest expense on debt to the same rate, so that an identical normal return on debt and equity is untaxed. Another method could be one general allowance rate for total corporate capital (see Annex 18 for more details).

- For the wage part, the normal return to labour can be exempted by providing an allowance for ‘normal’ remuneration. Such ‘normal’ remuneration per employee could be for instance defined as the average remuneration in other non-financial sectors, possibly correcting for the type of functions¹¹.

2.5.3. *Option 2C: The risk-taxing FAT (FAT3)*

A third version of the FAT would tax excess return due to unduly risky activities. This version of the FAT is very similar to the rent-taxing FAT because would leave untaxed the “normal profit” and the “normal remuneration for labour”. However, the risk-taxing FAT would determine the ‘normal profit’ by adjusting the P&L result with a higher ACE (i.e. higher ‘normal’ return for corporate equity), so that only the excessive return to (average) equity is taxed.

The reason is that this excessive return is arguably the result of high risk-taking activities. Therefore, parts of the rents could theoretically be untaxed as long as the return to equity does not exceed this threshold. Similarly to the FAT2, only expenses for remuneration for labour over a certain threshold would also be added-back to the P&L result and be, consequently, taxed.

2.6. **The tax rate**

The Commission SWD has used a 5% rate for illustrating the revenue collection potential of the FAT. However, the appropriate FAT rate would depend on the revenue collection expected and on the other objectives pursued by the introduction of the FAT (mostly on the FAT taxable base).

An argument could be made in favour of an FAT rate equal to the VAT rate, so that the FAT best addresses the VAT exemption of financial services. However, to the extent that financial institutions may not recover input VAT, such a rate could excessively burden the sector.¹² Nevertheless, linking the FAT rate to the VAT rate applicable in the Member State would be an option worth considering in the final design of the FAT but this could be hampered by inconsistencies in the actual impact of non-recoverable VAT (see in particular Annex 17 for a discussion on these issues).

Economic literature proposing the cash-flow taxation as a substitute for the classical Corporate Income Taxation notes that the neutrality of the tax with respect to investment depends crucially on the tax rate being constant over time.¹³ In addition, a unique, or at least very similar, FAT rate applicable across the EU would probably be desirable in order to minimise distortions and to ease the application of the methods to avoid double taxation (both issues are further addressed below).

In summary, tax neutrality would call for an FAT rate lower than the VAT rate, which would be as harmonised and constant as possible for all EU Member States. The revenue estimations

provided under section 6.2.2 are calculated using a 5% tax rate for FAT which corresponds to the minimum reduced VAT rate in the EU.

2.7. Double taxation issues

The introduction of an FAT, in whatever of the forms described above, would cause different double taxation issues, which must be distinguished. First, there is the treatment of losses under FAT and the risk that the profits of a certain financial institution operating in several EU Member States be taxed twice or multiple times under the FAT of different Member States. Secondly, there is the interaction between FAT and other existing taxes, notably the VAT, which are generally referred to as cascading effects, but also with CIT (even in non-EU Member States). They are addressed below separately.

2.7.1. Treatment of losses under FAT

Each type of FAT calls for a different treatment of the losses, since each of them would pursue a different goal:

- Addition method FAT or FAT1: symmetrical treatment of gains and losses, this is, carry-forward of losses should be allowed.
- Rent-taxing FAT or FAT2: the carry-forward of losses should be allowed so that the tax falls on pure economic rents.
- Risk-taking FAT or FAT3: Allowing the carry forward of losses would not help discouraging highly-risky activities, because the losses in one year would be used to compensate excessive risk-taking in other years. Carry-forward of losses should therefore not be permitted under the FAT3.

2.7.2. FAT Double taxation - relief for losses and for FAT in other countries

To the extent that the FAT is introduced in all EU Member States in a coordinated fashion, FAT double taxation should not be too complex to avoid at least in a purely EU context. Indeed, the more coordinated the FAT across EU Member States, the less complex would be to design an effective method to avoid double taxation.

If the FAT is levied on an entity-per-entity level on a stand-alone basis, a method of imputation or exemption of dividends could be envisaged to relief double taxation in a profit-making context. This, however, would leave unsolved the taxation in loss-making situations (provided that a FAT allowing the compensation of losses is adopted). Technical rules on the treatment of losses made by group entities in different Member States would probably be needed so that the FAT is as neutral as possible within the EU.

Another possibility would be to have the FAT applied on a consolidated base at EU level. The current proposal on a Common Consolidated Corporate Tax Base (CCCTB) could serve as a model to arrive to an EU-harmonised FAT tax base.

2.7.3. *FAT-VAT interaction: cascading effects*

The interaction (or rather, the lack of it) between the FAT and the VAT would be similar to the interaction between VAT and any other direct tax. This is, to the extent that the FAT would not be assessed on a transaction-per-transaction basis, it would not be possible to have the FAT properly invoiced on transactions between financial institutions and business subject to VAT. The financial institutions subject to FAT would not be able to credit input VAT against their payable FAT (the problem of non-recoverable VAT is further analysed in Annex 17). In addition, business subject to VAT would not have the possibility to credit the FAT for VAT purposes or to obtain credit for the unrecoverable VAT borne by the financial institutions from which they have received financial services.

Some technical measures have been suggested to try to alleviate the cumulative effect of having two different taxes, VAT and FAT, on the same concept (value added). It has been proposed to allocate credits for FAT to business on the basis of an approximation, or to have an FAT rate lower than the VAT rate. None of these solutions seems entirely satisfactory but further technical work may be carried out to minimise this distortion. As more fully explained in Annex 17, the potential integration of FAT and VAT would also very much depend on whether the VAT exemption of the financial services is kept in the current terms or whether a form of taxing them for VAT purposes is introduced.