Analysis

Financial transaction tax & the corporate treasury

SPEED READ **The European Commission presented a new proposal for a financial transaction tax directive on 14 February. The broad scope of the directive means that the financial transactions undertaken by the treasury functions of many UK multinational corporate groups may be caught by the tax. The proposed FTT, which is due to come into force on 1 January 2014, will apply to each party to a transaction that is a financial institution and to each link in a chain of transactions. This can lead to multiple charges for effectively the same transaction, and is likely to impact heavily on many UK corporate treasury functions with risk management centralised in a single entity. UK corporate groups should, therefore, continue to monitor the progress of the directive as the detail is finalised.**

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The financial transaction tax (FTT) will be levied on certain financial transactions. When the original proposal was issued, it was anticipated that the FTT would apply in every EU Member State. However, with countries including the UK, Denmark, Sweden and Ireland refusing to support the proposal, the only route left available for countries keen to support an EU-level FTT was to pursue the enhanced cooperation procedure requiring consent of at least nine Member States. On 22 January, EU finance ministers (ECOFIN) adopted the decision to allow a FTT based on enhanced cooperation between 11 participating Member States – Germany, France, Italy, Spain, Portugal, Greece, Austria, Belgium, Estonia, Slovakia, Slovenia – to be open to any other Member States which subsequently choose to join).

The term 'financial transactions' is defined widely but, broadly speaking, will include:

- the purchase and sale of financial instruments;
- the conclusion of derivative contracts;
- an exchange of financial instruments; and
- repo and securities lending arrangements.

'Financial instruments' takes its definition from the Market in Financial Instruments Directive (2004/39/EC Annex 1, Section C) and includes, but is not limited to, transferable securities including shares, money market instruments, cash settled derivative contracts and physically settled commodity contracts where the contract is traded on a regulated market or a multilateral trading facility. Importantly, primary market transactions are excluded from the scope, meaning that debt and equity issuances should not be liable to the FTT.

Given the context of this proposal, with references to the financial sector's role in the global economic crisis and the case for their making a fair contribution to dealing with its consequences, it is perhaps not surprising that many UK multinational groups operating outside the financial services sector have not focused on the FTT and how it may impact them. And why would they? They are neither financial institutions as is commonly understood, nor are they established in the FTT zone. However, the scope of the directive is deliberately very broad and, as a result, the financial transactions undertaken by the treasury functions of many UK multinational corporate groups may fall within the scope of the tax.

The scope of the FTT is set out in art 3(1) of the directive:

'This directive shall apply to all financial transactions, on the condition that at least one party to the transaction is established in the territory of a participating Member State and that a financial institution established in the territory of a participating Member State is party to the transaction ...'

Article 10 of the directive makes it clear that it is only financial institutions that have a primary liability to the FTT (although others may have a secondary, joint and several, liability).

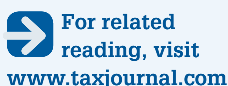
Therefore, there must be a financial institution and it must be established in a participating Member State (that is to say, established within the FTT zone). Where this is the case, the financial transactions which it undertakes will be liable to the FTT.

Is our group treasury company really a financial institution?

'Financial institution' is defined in art 2 para 2(3) of the directive and includes entities within the financial services sector such as banks and insurance companies. However, more relevantly to non-financial groups, the definition of 'financial institution' also includes any body or person carrying out any certain specified activities, including the following which are often undertaken by corporate treasury departments:

- acceptance of deposits;
- lending;
- finance leasing; and
- participation in derivative contracts,

where the average annual value of its 'financial transactions' constitutes more than 50% of its overall average net annual turnover. (This is a clarification from the original draft



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directive issued in September 2011 where the only requirement was that the financial transactions constituted a 'significant part of its overall activity'.) It is this definition which will potentially bring a significant number of corporate treasury companies within the scope of a 'financial institution'.

Article 2 para 3 clarifies how to quantify the value of financial transactions for the purpose of this test but, in summary, the value of financial transactions – other than those related to derivatives – is the market price or consideration for purchases and sales of the relevant securities, and for derivative contracts is an amount equal to 10% of the notional principal amount of all derivative contracts entered into. See Figure 1.

Based on this definition, it is easy to see how many treasury companies will fall within the definition of 'financial institution' and therefore potentially be liable to FTT on its financial transactions.

Is a treasury company incorporated and tax resident in UK outside the scope of the FTT?

Given the UK will not enact the FTT directive, this might seem like a sensible conclusion. However, the directive sets out the circumstances in which a financial institution is deemed to be established in an FTT zone territory. Article 4 para 1(f) is of particular relevance to group treasury companies. This states that a financial institution will be deemed established in the FTT zone where it enters into a financial transaction with a party which is established in the FTT zone whether or not the counterparty is itself a 'financial institution'. See Figure 2.

How will the directive impact non-financial services businesses?

It is worth noting that the FTT applies to each party to a transaction that is a financial institution and to each link in a chain of transactions. This can lead to multiple charges for effectively the same transaction. Many UK corporate treasury functions seek to centralise risk management in a single entity. There are several benefits to this including better oversight and management of risk to the group and access to better pricing. Therefore, it is not uncommon for subsidiaries of UK headquartered groups to enter into transactions with the UK group treasury function in order to manage their own risks, with the UK group treasury company hedging this resulting risk in the market. See Figure 3 (overleaf).

Compliance obligations

The directive sets out minimum rates for the tax that remain unchanged from the original proposal at 0.1% for transfers etc of bonds and shares and 0.01% of the notional value of any

The scope of the directive is deliberately very broad and, as a result, the financial transactions undertaken by the treasury functions of many UK multinational corporate groups may fall within the scope of the tax

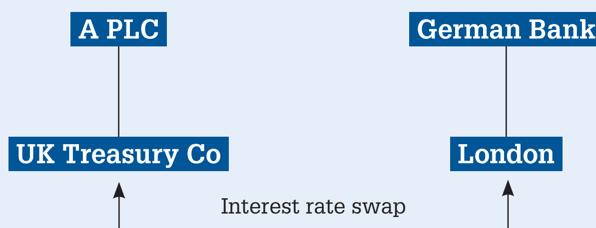
Figure 1: Determining whether a financial institution

Where a person undertakes one or more of certain specified activities including, but not limited to, acceptance of deposits, lending, finance leasing and participating in derivative contracts:

Average annual value of person's financial transactions (to include gross value of both long and short positions in securities and 10% of notional principal of all derivatives) > 50% of person's overall average net annual turnover = 'Financial institution'

Figure 2: How UK treasury companies can be caught by the FTT

Consider the following scenario. The UK treasury company of A PLC is a 'financial institution', as defined, and enters into an interest rate swap. The counterparty is the London branch of German Bank.



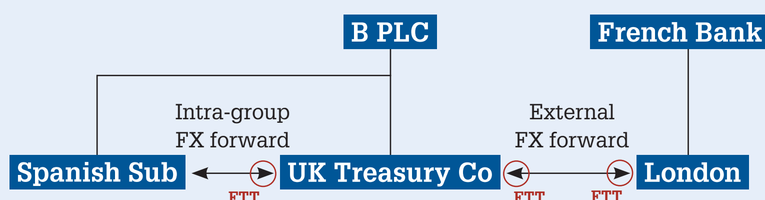
The German Bank is clearly established in the FTT zone as it will be authorised by the German authorities to act as a financial institution (and in any event has its registered seat in Germany). UK Treasury Co, however, is not authorised to act as a financial institution by an FTT zone Member State, nor does it have a registered seat, permanent address or branch located in the FTT zone. Nevertheless, the fact that it enters into the interest rate swap with the London branch of the German Bank is sufficient to deem UK Treasury Co to be established in Germany with respect to that interest rate swap for the purpose of the directive.

As a result, FTT will be levied on the German Bank on it entering into the interest rate swap and will also be levied on UK Treasury Co, as it is a 'financial institution' that is deemed established in Germany. The FTT is payable by UK Treasury Co to the German tax authorities as that is the Member State in which is it deemed established.

As a result of this definition of establishment, many companies that would not ordinarily consider themselves to be established anywhere other than the UK, may in fact find that they are deemed established in the FTT Zone and liable to FTT, at least in relation to certain transactions.

The FTT applies to each party to a transaction that is a financial institution and to each link in a chain of transactions

Figure 3: The impact on non-financial services businesses



In this example, let us assume that the Spanish Sub wishes to hedge a proportion of its US dollar denominated sales. It therefore enters into an FX forward with UK Treasury Co to sell US dollar for euro. UK Treasury Co also enters into an FX forward but this time with the London branch of a French Bank. Under this contract, UK Treasury Co also agrees to sell US dollar for a fixed amount of euro. This FX forward (the 'external FX forward') not only provides a hedge of UK Treasury Co's exposure at an individual entity level created by the intra-group FX Forward, but it also provides the group with a cash flow hedge of the Spanish Sub's US dollar denominated sales in the consolidated accounts.

As discussed previously, the French Bank is clearly established in an FTT zone Member State as it is authorised by the French authorities to act as a financial institution (and in any event has its registered office in France), therefore the French Bank will be liable to FTT on the external FX forward. UK Treasury Co will also be deemed to be established in France by virtue of the External FX Forward which it enters into with the French Bank. This means that UK Treasury Co, as a 'financial institution' will be liable to FTT on the external FX forward in France. As UK Treasury Co is a 'financial institution' for the purposes of FTT, it is also necessary to consider its position with respect to the intra-group FX forward.

The counterparty to this contract is a company that is established in Spain. The fact that the Spanish Sub is not itself a 'financial institution' is not relevant. As we discussed above, a UK company will be deemed to be established in an FTT Zone Member State where the counterparty to the financial transaction is established in the FTT Zone, irrespective of whether the counterparty is a 'financial institution'. As a result, UK Treasury Co is treated as established in Spain in respect of the intra-group FX Forward and therefore should be liable to FTT in Spain on the intra-group forward. It is worth noting that if the Spanish Sub itself satisfies the definition of a 'financial institution', a fourth charge to FTT would arise in respect of this series of transactions.

It is conceivable that the FTT payable by the French Bank might be passed onto the B PLC group through the pricing of the derivative, however if this were to be the case, banks within the FTT zone would not be competitive with banks established outside this zone and therefore it is not certain that this would happen. As a result, in the arrangement set out above, UK Treasury Co would suffer a minimum of two charges to FTT on the same arrangement. If the French Bank's FTT charge were to be passed onto the B PLC group, this would result in a third charge to FTT.

derivatives with the payment of this tax due either:

- immediately, where the transaction is carried on electronically; or
- within three days in all other cases.

Furthermore, an FTT return must be submitted on a monthly basis within ten days of the end of the month in which the FTT liability arises.

The compliance obligations imposed on companies will be onerous and companies will need to ensure that they have good systems in place in order to comply with the directive and meet their obligations. This will involve separating financial transactions by location and status of counterparty, and place of issuance of the financial instrument; and having systems to report to and account to the tax authorities of the participating countries, bearing in mind that they may not necessarily set the same rates or procedures for the operation of the tax.

Timing

Given that the directive is intended to take effect for financial transactions entered into on or after 1 January 2014, this would leave little time to implement a robust and effective system. Whilst many policy makers across the EU are expecting this date to change, there is no consensus on how long the implementation of the directive might be deferred.

Conclusion

This article has focused primarily on the application of the directive to derivative transactions entered into by group treasury companies. For many groups who enter into a significant number of derivatives in order to hedge risks arising to their group – such as interest rate, currency and commodity risk – this may result in an unacceptably high pre-tax cost for such arrangements.

Clearly the scope of the directive is much wider and could apply to other financial transactions and other entities which, although not regulated entities, fall within the extensive definition of 'financial institution' included within the directive. In particular, it is worth noting that the definition of 'financial institution' also includes pension funds, something which has been the cause of much concern.

However, what is clear is that despite the fact that the UK will not participate in the directive, UK corporate groups may be impacted by the directive and action must be taken to assess the potential impact on the group and to identify any steps which might be taken to mitigate its effect.

It will therefore be important for UK corporate groups to continue to monitor the progress of the directive as the detail is finalised.

The proposed council directive 2013/0045 (CNS) implementing enhanced cooperation in the area of financial transaction tax is available at www.lexisurl.com/FTTdirective. ■