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European Union Committee

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Financial Transaction Tax: Alive and deadly

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The European Union Committee

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Evidence

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Q refers to a question in oral evidence.
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SUMMARY

The European Commission's proposal for a Financial Transaction Tax (FTT), whilst always contentious, has been made even more so by the decision in 2012 of 11 Member States to take forward an FTT under the enhanced cooperation procedure. This Committee has consistently warned of the potential impact of an FTT on non-participating Member States, including the UK.

A Council Legal Service opinion has concluded that the proposal does not comply with EU law. We reject the artificial distinction between the FTT's imposition and its collection, which the Commission draws in order to play down the impact of its proposal for the 11 participants on the non-participating majority of Member States. We believe that impact would be considerable. The tax would have to be levied in the UK on behalf of the 11, with potential damage to our markets but no benefit to the Exchequer. All EU markets would suffer if, as we think likely, the effect were to drive transactions offshore.

The Commission's approach to enhanced cooperation in relation to the FTT has been both unjustified and misconceived. The Commission first brought forward a decision for the Council to authorise the use of enhanced cooperation. It was only after the Council had agreed this decision that the Commission brought forward a revised FTT proposal, which included material changes from the original proposal. This approach undermines the Commission's obligations to defend the interests of participating and non-participating Member States alike. We were surprised by the Commission's assertion that its proposal was deliberately radical, with the intention that the participating Member States could cut out what they disliked.

The UK Government's diffident approach to the FTT, and its reluctance over several months to take seriously this Committee's arguments and concerns, has been deeply frustrating to witness. It was only after constant and repeated warnings on our part that the Government finally awoke to the serious threat to the UK's, and the broader EU's, interests that an FTT pursued by other Member States might present. We welcome the steps that the Government have now taken to launch a legal challenge against this exercise of enhanced cooperation.

Financial Transaction Tax: Alive and deadly

Background

1. This is an update report on the European Commission's proposal for a Financial Transaction Tax (FTT). It takes account of important developments since the publication of our March 2012 report, *Towards a Financial Transaction Tax?*,[1] in particular the decision of 11 EU Member States to pursue an FTT under the 'enhanced cooperation' procedure.

BOX 1

Outline and objectives of the FTT

In its Explanatory Memorandum to its latest proposal to put in place an FTT by enhanced cooperation the Commission highlight the following objectives:

(a) To avoid fragmentation of the internal market for financial services, bearing in mind the number of uncoordinated national tax measures being put in place;

(b) To ensure that financial institutions make a fair contribution to covering the costs of the recent crisis and to ensure a level playing field with other sectors from a taxation point of view;

(c) To create appropriate disincentives for transactions which do not enhance the efficiency of the financial markets and thus trigger over-investment in activities which are not welfare enhancing and could contribute to future crises in the financial sector.

The Commission's earlier proposal for an FTT to be adopted by all Member States had an additional aim of creating a new revenue stream which could gradually displace national contributions to the EU budget, leaving a lesser burden on national treasuries. The earlier proposal was also seen by the Commission as paving the way towards a coordinated approach with the most relevant international partners. Both these aspects of the original proposal have less relevance to an FTT in which only a minority of Member States participate. In particular, the fact that the FTT is being taken forward by 11 Member States now makes it very unlikely that the proceeds could be used as a revenue stream for the EU budget. Therefore the sums raised by it would be retained by the participating Member State imposing the tax.

The tax would be imposed on a wide range of financial transactions[2] in respect of which at least one party to the transaction is a financial institution[3] "established" in a Member State which has opted to participate in the FTT.

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[1] House of Lords European Union Committee, *Towards a Financial Transaction Tax?* (29th Report, Session 2010–12, HL Paper 287).

[2] This includes instruments negotiable on the capital market, money market instruments (other than instruments of payment) units or shares in collective investment undertakings and derivatives contracts.

[3] This term is also widely defined and includes investment firms, credit institutions, insurance and reinsurance undertakings, undertakings for collective investments in transferable securities, pension funds and alternative investment funds.

An institution would be established in a Member State if any one of the following apply:

(a) It is authorised by the authorities of that Member State to act in the transaction concerned.

(b) Its registered seat, permanent address or usual residence is within that Member State.

(c) It has a branch within the Member State involved in the transaction.

(d) It is a party to a financial transaction with a financial institution established in a Member State in accordance with points a) to c) above; 'the deemed establishment principle'.[4]

(e) It is a party to a financial transaction in respect of a structured product or financial instrument issued within that Member State; 'the issuance principle'.

These rules do not apply if the financial institution is able to prove that "there is no link between the economic substance of the transaction and the territory of any participating Member State".

The FTT would be payable by each financial institution which is a party to the transaction or is acting in the name of a party to the transaction or on whose account the transaction is carried out.

The FTT would be charged at the rate fixed by the Member State concerned, which would be not less than 0.1% of the consideration paid by the financial institution concerned or the market price of the transaction if that is higher. The minimum rate of tax for derivatives contracts would be 0.01%.

To ensure payment of the tax, each financial institution would be jointly and severally liable to pay the tax due from any other financial institution liable to pay the FTT on the transaction concerned. The Commission estimates that such an FTT would generate revenue of €31 billion per annum.

The Committee's 2012 report

2. In October 2011, this Committee launched an inquiry into the Commission's recently published proposals for a Financial Transaction Tax, considering the potential risks and benefits of an FTT and its significance for the City of London. We also sought to assess whether an FTT could plausibly be implemented at EU level, or whether it would work effectively only if implemented globally. We heard evidence from economists, campaigners, financial institutions and representative organisations, as well as from the then Financial Secretary to the Treasury, Mark Hoban MP, and from the European Commissioner for Taxation and Customs Union, Audit and Anti-Fraud, Algirdas Šemeta.

3. The Committee's 2012 report, *Towards a Financial Transaction Tax?*, found the Commission's proposal wanting in many respects, and unlikely to fulfil the objectives that the Commission had itself set. The Commission's own Impact Assessment was subject to severe criticism and was in any case itself surprisingly unsupportive of the Commission's case. We called into question the so-called 'residence principle' (upon which the proposal was based),

4 See para 3 below.

according to which the FTT would be imposed by the Member State of establishment or authorisation of the financial institution, regardless of where the transaction took place. This principle might extend to the imposition of FTT on financial institutions in non-participating EU Member States and third countries in respect of financial transactions with counterparties based in the FTT area—the 'deemed establishment principle'.

4. We concluded that there was a significant risk that financial institutions would relocate outside the EU if an FTT was introduced, with serious consequences not only for the City of London but for the EU financial services industry and ultimately for the health of the EU economy as a whole. In our view, only an FTT implemented on a global scale would prevent EU-resident institutions being placed at a significant competitive disadvantage. Yet we found the suggestion that the proposal would pave the way for a global tax wholly unrealistic, and the proposition that it could be used as a revenue stream for the EU budget highly contentious. Although the Committee acknowledged the strength of public anger directed against the financial sector, and the widespread view that those who contributed to the financial crisis should contribute to its costs, we judged that this proposal was the wrong way to address those concerns.

5. A number of Member States appeared to share the Committee's concerns, not least the UK itself, which announced at an early stage that it would not participate in an EU-wide FTT. As a taxation proposal, the FTT required unanimous support amongst Member States, and it was quickly evident that such support would not be forthcoming. It was therefore no surprise when negotiations ground to a halt in the summer of 2012.

Subsequent developments

6. However, in June 2012, a number of Member States who supported the proposal, led by Austria and Germany, announced their intention to take forward an FTT under the 'enhanced cooperation procedure'.[5] In advance of the 9 October 2012 meeting of the Economic and Financial Affairs Council (ECOFIN), France and Germany wrote to all Member States calling for an FTT to be taken forward under enhanced cooperation. As a result, nine Member States (Austria, Belgium, Estonia, Greece, Italy, Portugal, Slovakia, Slovenia and Spain) joined France and Germany in writing to the Commission requesting the introduction of an FTT under enhanced cooperation. The Commission issued an authorising Decision proposal on 23 October 2012,[6] having concluded that such a proposal was consistent with the provisions of the Treaties. This was agreed at the 22 January 2013 meeting of ECOFIN, at which time the UK abstained.[7]

7. Three weeks later, on 14 February 2013, the Commission published its substantive proposal for a Directive implementing enhanced cooperation in the area of financial transaction tax.[8] Although based on the Commission's original proposal, the new proposal included extensive consequential and much technical redrafting. Importantly, it incorporated new anti-avoidance

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5 For a full account of the use of the enhanced cooperation procedure, see below, paras 24–30.

6 COM (2012) 631 FINAL.

7 Decision 2013/52.

8 COM (2013) 71 FINAL.

provisions, including the very significant 'issuance principle', which had not been disclosed when the decision on enhanced cooperation was reached.

8. Negotiations on the new proposal continued over subsequent months, albeit at a slow pace. Media reports emerged that the participating Member States were unable to agree amongst themselves concerning the design of the tax, and that some of them were getting cold feet.[9] There was also a perception that the run-up to the German Federal elections on 22 September 2013 had slowed the pace of progress even further.[10] At a roundtable meeting of our Committee on 23 July 2013 with charities, campaign organisations and trade union representatives, at which a number of participants put the case for the FTT, David Hillman, Director, Stamp Out Poverty, told us that an FTT would be high on the agenda if, after the German elections, a Grand Coalition between the CDU/CSU and the SPD was formed.[11] Developments in Germany since the elections appear to have borne this judgment out. On 27 November, a programme for a Grand Coalition was agreed (subject to ratification by SPD party members) which included a commitment to the speedy introduction of an FTT to cover shares, bonds, investment funds, currency trades and derivatives.[12]

9. On 10 September 2013, new media reports emerged that the opinion of the Legal Service of the Council had identified a series of negative aspects of the revised FTT.[13] That opinion, as leaked,[14] concluded that the deemed establishment principle did not comply with the Treaty conditions for enhanced cooperation because:

- It exceeded Member States' jurisdiction to impose tax extraterritorially;
- It infringed the competences of non-participating Member States;
- It was discriminatory and likely to lead to distortion of competition to the detriment of non-participating Member States.

10. The Commission moved quickly to reject this opinion. Commissioner Šemeta stated that "FTT is legally sound and fully complies with EU treaties and international law".[15] We were told that a full Commission Legal Service opinion would be produced, although it was not clear whether this opinion would be placed in the public domain.[16] No formal Commission legal opinion has yet been published.

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9 Wishart, I (2013) 'Clarification required on financial transaction tax', *European Voice*, 25 April 2013.

10 Barker, A (2013) 'Europe financial transaction tax hits legal wall', *Financial Times*, 10 September 2013.

11 House of Lords European Union Sub-Committee on Economic and Financial Affairs roundtable meeting with charities, campaign organisations and trade union representatives, 23 July 2013: http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/CityUK/Roundtablewebsite.pdf. This matter was also discussed at the roundtable meeting with representatives of TheCityUK, 11 June 2013: http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/CityUK/CityUKwebsite.pdf.

12 Wagstyl, S., and Vasagar, J. (2013) 'Merkel secures agreement for coalition of right-left parties', *Financial Times*, 28 November 2013.

13 'Europe financial transaction tax hits legal wall', *Op. Cit.*

14 FT Brussels blog, 10 September 2013, by Alex Barker. See http://blogs.ft.com/brusselsblog/2013/09/eu-legal-opinion-against-the-ftt-full-text/.

15 Vogel, T. (2013) 'Financial Transaction Tax breaks EU law', *European Voice*, 10 September 2013.

16 Evidence by Heinz Zourek, Director General, DG Taxation and Customs Union, European Commission, to the House of Lords European Union Sub-Committee on Economic and Financial Affairs, 2 October 2013, Q 1.

The Committee's scrutiny of these developments

11. In our March 2012 report the Committee warned the Government that, notwithstanding their opposition to the proposal, it was imperative that they remained actively engaged in the debate. This was particularly important given our conclusions concerning the potential impact of the tax on the UK, even if the UK chose not to participate in the tax. We found that UK financial institutions entering into transactions with financial institutions in participating Member States would still be liable for the FTT, which would have to be collected by UK tax authorities through the mechanism of EU mutual assistance for the recovery of tax[17] or by exploiting the provisions making each taxpayer jointly and severally liable for the FTT owed by other parties to the financial transaction. Our fear was that UK financial markets would be damaged by these provisions, without benefitting from the relocation of activity away from the FTT zone that third country centres such as New York, Hong Kong and Singapore might expect. The working of the mutual recovery regime and an example of how it and the application of joint and several liability could apply to the FTT are set out in Box 2.

BOX 2

The Mutual Recovery Directive and the FTT

The Mutual Recovery Directive enables one Member State to request another to recover tax owed to it once the tax debt becomes enforceable and it has become clear that collection in the requesting Member State is not possible. It applies in principle to all taxes and therefore a future FTT could be collected through the regime established by this Directive.

The debtor can only challenge the imposition of the tax in the requesting Member State, but if the tax is challenged there, mutual recovery must be suspended until that matter is resolved.

The requested Member State must seek to collect the tax[18] using the legal tools available under its own tax collecting regime. It must charge interest on late payment according to its own laws as from the date of receiving the request. It must also seek to recover its costs.

The requested Member State must account to the requesting Member State for tax and interest recovered, but may retain costs recovered.

An example of how the mutual recovery regime could apply to the FTT is as follows: A transaction involving a structured product issued in an FTT Member State carried out in New York by financial institutions which were not established in a participating Member State would nevertheless be subject to the FTT under the issuance principle. If one of the parties to that financial transaction was established in the UK then the tax authorities of the FTT Member State would be able to request HMRC to collect and account to them not only for the FTT imposed directly on the UK financial institution, but also that imposed on any third country counterparty, on the basis of joint and several liability.

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17 Directives 2010/24 and 2011/16.

18 There are only very limited grounds for refusing: for small claims, for claims more than five years old, and if recovery would "because of the situation of the debtor, create serious economic or social difficulties in the requested Member State".

12. We had urged the Government to work to ensure that UK financial institutions were not damaged by an FTT introduced by a smaller group of EU Member States.[19] However, we detected over the following months a marked complacency within HM Treasury as to the potential deleterious impact of the tax on the UK. It appeared to us that the Government had seriously underestimated the political will amongst the FTT's advocates to see the proposal succeed. The Government had also appeared to make the premature assumption that the FTT was doomed to failure. This poor judgement was compounded in particular by the inadequate quality of the Government's response to our report, which failed to address our central concerns about the potential effect of the tax on UK institutions and tax authorities.[20] Indeed, at first, the Government's assessment appeared to be that the UK stood to benefit from an FTT imposed by other Member States.[21]

13. We found the Government's approach to be unsatisfactory, both in their complacency over the potential impact of the tax and in their failure to engage with the Committee's arguments. We reiterated our concern that the proposal would damage EU capital markets, including the UK. Yet the UK, in choosing not to participate, would not benefit from any tax receipts that accrued. On the contrary, the structure of the tax would mean that UK financial institutions would still be liable for the FTT. We pressed the Government on the work they were undertaking to ascertain the impact on the UK of an FTT taken forward under the enhanced cooperation procedure, the impact of such a tax in terms of relocation of financial transactions, and the subsequent impact of such relocation on the City of London and other world markets.[22] We continued to pursue such matters with the Government over a number of months until finally, in May 2013, the then Financial Secretary to the Treasury, Rt Hon Greg Clark MP, conceded that such an FTT could indeed "carry an array of significant negative impacts" for the UK.[23]

14. One of our main criticisms of the Government was their approach to the 22 January 2013 ECOFIN vote authorising the use of enhanced cooperation. In light of the fact that the revised proposal had yet to be published, it was our view that the Government should have voted against the authorising decision, and sought to encourage other non-participating Member States to do the same.[24] Instead, the Government chose to abstain, arguing that attempting to block others from proceeding would undermine the principle of national sovereignty over taxation matters, and that, under qualified majority voting, an abstention had the same effect as a vote against in any

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19 Towards a Financial Transaction Tax?, *Op. Cit.*, Chapter 4.

20 Government response to the House of Lords European Union Committee report, *Towards a Financial Transaction Tax?*, 24 May 2012. See http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/FinancialTransactionTax/FTTGovResponse.pdf.

21 Letter from Mark Hoban MP, Financial Secretary to the Treasury, to Lord Boswell, Chairman of the House of Lords European Union Committee, 17 July 2012. See also Wilson, H. (2013) 'German and Italian banks should move to UK if FTT introduced, says Boris Johnson', *Daily Telegraph*, 22 July.

22 See for instance letter from Lord Boswell to Rt Hon Greg Clark MP, Financial Secretary to the Treasury, 20 November 2012.

23 Letter from Rt Hon Greg Clark MP to Lord Boswell, 25 May 2013.

24 Letter from Lord Boswell to Rt Hon Greg Clark MP, 26 March 2013.

case.[25] In our view, strenuous objection might have proved fruitful, with fewer than one half of Member States advocating the tax.

15. On 19 March 2013, the Committee took evidence from Manfred Bergmann, Director of Indirect Taxation and Tax Administration, DG TAXUD, European Commission, on the Commission's revised proposals. Mr Bergmann told the Committee that there would be no legal obligation on UK tax authorities to collect the tax.[26] We were surprised by his argument. Indeed, we warned that, under the proposed issuance principle, in the case of a financial transaction involving German shares[27] between a US and a UK financial institution, collection of the tax from the US financial institution in particular might be difficult. We put forward the example outlined in Box 2 above.[28]

16. In light of the evidence we heard, we wrote to the Minister on 26 March 2013 to state that, in our view, the proposal failed to meet the criteria for enhanced cooperation, and in particular the requirement to respect the competences, rights and obligations of those Member State which do not participate in it. We found it particularly unacceptable that a full analysis of the impact of the proposal on non-participating Member States was not made available by the Commission before the 22 January ECOFIN vote. We therefore urged the Government to take urgent legal advice on the case for a legal challenge at the European Court of Justice.[29]

17. On 17 April 2013, the UK Government made an application to the European Court of Justice for the annulment of the Council Decision authorising enhanced cooperation in the area of financial transaction tax. The application focused on the extraterritorial elements of the tax. In the Government's view, if the FTT Directive were to be adopted in its current draft form, the tax would infringe the rights and competences of non-participating Member States by departing from accepted international tax norms. Specifically, the Government voiced concerns about the proposed deemed establishment principle. They considered this likely to breach the conditions for enhanced cooperation and to be in conflict with international tax law and customary international law.[30]

18. In his letter to the Committee of 18 April, the then Financial Secretary to the Treasury acknowledged that, as the Committee had consistently argued, the tax in the form proposed by the Commission could indeed oblige UK tax authorities to collect the FTT under existing EU agreements on mutual assistance and recovery. In the Government's view, this raised fundamental concerns, as Article 332 TFEU provides that expenditure resulting from implementation of enhanced cooperation shall be borne by the participating Member States unless all Member States agree otherwise. As a result, the Government also challenged the Directive on these grounds.[31] The Minister

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25 Letter from Rt Hon Greg Clark MP to Lord Boswell, 25 May 2013, *Op. Cit.*

26 Evidence to the House of Lords European Union Sub-Committee on Economic and Financial Affairs, 19 March 2013, Q 5.

27 For instance, Volkswagen shares.

28 Letter from Lord Boswell to Algirdas Šemeta, European Commissioner for Taxation and Customs Union, Audit and Anti-Fraud, 16 April 2013.

29 Letter from Lord Boswell to Rt Hon Greg Clark MP, 26 March 2013, *Op. Cit.*

30 Letter from Rt Hon Greg Clark MP to Lord Boswell, 18 April 2013.

31 *Ibid.*

added that the grounds on which the Government had challenged the authorising decision were all points on which the Committee had previously flagged concerns.[32] The UK's legal challenge remains before the Court.

19. In our letter to Commissioner Šemeta of 16 April 2013, we criticised the Commission for its failure to provide any detailed analysis of the potential adverse effects on non-participating Member States in its Impact Assessment. We asked the Commission to provide us with a categorical statement of the obligation or otherwise that would be placed on UK authorities to collect the tax, in light of Article 10 of the proposal and Directive 2010/24.[33]

20. After repeated requests failed to elicit a response to this point, the Committee decided to take evidence from Heinz Zourek, Director General, DG Taxation and Customs Union, European Commission, in Brussels on 2 October 2013, both on this matter and on the Commission's response to the Council Legal Service opinion. Mr Zourek assured us that the Commission's response to the Committee's request would be received imminently. The Commission response was finally received on 31 October 2013, over six months after our first request.[34]

This update report

21. In light of such significant developments since the publication of our first report, we have decided to publish this short update report. Our findings take particular account of the Council Legal Service opinion, the views expressed at the Committee roundtable meetings held in June and July 2013,[35] the evidence heard in Brussels on 2 October 2013 from Mr Zourek and the subsequent letter from Commission Vice-President Maroš Šefčovič of 31 October 2013. We are particularly grateful to Mr Zourek for meeting us.

22. In our first report, we acknowledged that, notwithstanding our concerns about the Commission's proposals, there was a legitimate debate about whether and how the financial sector should be taxed. We again acknowledge that there is a view that the financial services sector is under-taxed (because it is not subject to VAT), that it will be necessary to find new sources of funding to provide for a bank resolution fund in the euro area, and that, whilst an FTT will have distortionary consequences (for example high frequency trading could suffer significantly) and may lead to the displacement of business from participating to non-participating Member States or from the EU to overseas markets, the scale of these effects is not yet clear.

23. Nevertheless, on the basis of the evidence we have heard, and as we set out in more detail below, our view remains on balance that the proposal to take forward an FTT under enhanced cooperation, along the lines proposed by the Commission, could have a significant detrimental effect not only on the UK but on all EU Member States, whether they choose to participate or not. In this respect, we focus on two issues in particular:

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32 Letter from Rt Hon Greg Clark MP to Lord Boswell, 25 May 2013, *Op. Cit.*

33 Letter from Lord Boswell to Commissioner Šemeta, 16 April 2013, *Op. Cit.*

34 Letter from Maroš Šefčovič, Vice-President, European Commission, to Lord Boswell, 31 October 2013.Although the letter states that it is a reply to the Committee's letters of 30 July and 10 September 2013, it responds primarily to the questions first set out in the Committee's letter of 16 April 2013.

35 See above, para 8.

- The appropriateness of the use of the enhanced cooperation procedure;
- The implications of the Council Legal Service opinion.

The use of the enhanced cooperation procedure

24. The Treaties[36] provide that a group of at least nine Member States may negotiate and adopt legislation binding only on themselves and any other Member State which subsequently wishes to join in under a process known as enhanced cooperation. The conditions for the use of enhanced cooperation and its relationship with general EU law are set out in Box 3.

BOX 3

The enhanced cooperation procedure

The Treaty conditions governing enhanced cooperation are as follows:

- Enhanced cooperation may only be adopted as a last resort when the Council has established that the objectives of the cooperation cannot be achieved by the EU as a whole within a reasonable time.
- It must aim to further the objectives of the Union, protect its interests, and reinforce its integration process.
- The Decision authorising enhanced cooperation as it applies to the FTT must be proposed by the Commission and adopted by the Council acting by qualified majority, having obtained the consent of the European Parliament.
- At least nine Member States must participate. Others may join at a later stage.
- Enhanced cooperation must not undermine the internal market or the economic, social and territorial cohesion of the EU. It must not constitute a barrier to, or discrimination in, trade between Member States, nor shall it distort competition between them.
- It must respect the competences, rights and obligations of those Member States which do not participate in it.
- Non-participating Member States must not impede the implementation of enhanced cooperation.
- Expenditure resulting from implementation of enhanced cooperation, other than administrative costs entailed for the institutions, shall be borne by the participating Member States, unless all members of the Council unanimously decide otherwise.
- In the field of the FTT the proposed Directive implementing enhanced cooperation must be adopted unanimously by the participating Member States.

Although legislation adopted by enhanced cooperation only binds participating Member States it does form part of the EU acquis and can have knock-on effects on non-participating Member States. This is clearly the case

[36] Article 20 TEU and Articles 326 to 334 TFEU.

in the area of the FTT. Although the FTT would be a tax imposed only by participating Member States, it engages general EU legislation applicable to taxes, such as Directive 2010/24 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures.

25. It should be noted that although the enhanced cooperation procedure has been available since 1 May 1999[37] it has been sparingly used. Previous instances are set out in Box 4.

BOX 4

Previous use of enhanced cooperation

The first instance of enhanced cooperation arose in 2010 with a decision authorising enhanced cooperation in respect of the choice of the law that should be applied to divorces or legal separations involving a cross-border dimension. The proposal for the decision authorising enhanced cooperation and the proposed Regulation containing the substantive rules implementing it were both presented on the same day.[38]

The second instance concerned legislation to give unitary effect to the European Patent. In this case there was a four month gap between the proposal for a Decision authorising enhanced cooperation which was published by the Commission in December 2010 (and adopted in March 2011) and the proposals for Regulations implementing it, in April 2011.[39] The Decision authorising enhanced cooperation was challenged by Spain and Italy. The Court of Justice rejected these challenges in its judgment of 16 April 2013.[40]

26. In his evidence to us, Mr Zourek indicated that the Commission was surprised to be asked to propose enhanced cooperation in the field of taxation. He said that the Commission was overtaken by the speed of the process which was fuelled, in his view, by popular demand to generate revenue quickly and punish the financial institutions which caused the global crisis. He said that, as a result, the Commission had yet to collect all the information necessary to conduct a thorough analysis. He claimed that there were procedural reasons why the proposal for the substantive implementing Regulation could not have been made at the same time as the proposal authorising enhanced cooperation and that the Commission acted in this order for purposes of "reassurance". He added that the Commission had little margin for manoeuvre as it had to act on the request of the Member States wishing to established enhanced cooperation.[41] Mr Zourek also indicated that the Commission proposal was deliberately radical in that "you cannot easily imagine going further"; the idea being that the participating Member States could then cut out what they disliked.[42]

27. **In this particular case of the use of the enhanced cooperation procedure in relation to the FTT, the Commission has signally failed**

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37 The date of the coming into force of the Amsterdam Treaty.

38 Proposals COM (2010) 104 and 105. Authorising Decision 2010/405 and Regulation 1259/2010.

39 Proposals COM (2010) 790 COM (2011) 215 and COM (2011) 216. Authorising Decision 2011/167 and Regulations 1257/2012 and 1260/2012.

40 Joined cases C–274/11 and 295/11.

41 2 October 2013 evidence session, *Op. Cit.*, Q 11.

42 *Ibid.*, Q 6.

to demonstrate that it has taken full account of the interests of non-participating Member States. Its decision to bring forward a deliberately contentious proposal in a controversial policy area has also proved divisive. Indeed the way in which enhanced cooperation has been used in the case of the FTT risks undermining its viability as a tool in the future.

28. Having said this, we have some sympathy with Commission officials given the unenviable task they have faced. Under considerable political pressure, Finance Ministers of participating Member States have foisted on the Commission the impossible task of designing a workable tax for a minority of EU Member States in a very short period of time. **The sorry tale of the FTT negotiations thus far demonstrates the vital importance of participating and non-participating Member States alike, as well as the Commission, working together to ensure that the enhanced cooperation procedure is used in an appropriate and measured way.**

29. **The legal dispute that has ensued strengthens our view that the UK Government should have voted against, rather than abstained from, the decision to authorise use of the enhanced cooperation procedure and, given the impact of the proposal on non-participating Member States, should have sought to persuade others to do the same. The Government's diffident approach to the FTT, and their repeated reluctance to take seriously this Committee's arguments and concerns, has been frustrating to witness. It was only after constant and repeated warnings on our part that the Government finally awoke to the serious threat to the UK's, and the broader EU's, interests that an FTT pursued by other Member States might present. We welcome the steps that the Government have now taken to launch a legal challenge against this exercise of enhanced cooperation.**

30. **The history of this matter provides a lesson of general application to the use of the enhanced cooperation procedure. We recommend that in future cases the Commission ensures that it gives sufficient consideration to the position of non-participating Member States and demonstrates that it has done so in the documents supporting its proposals for enhanced cooperation. We do not consider that there is any Treaty impediment to the Commission bringing forward at the same time its proposal for a Decision authorising enhanced cooperation and its proposal for the substantive legislation implementing enhanced cooperation, and we recommend that it should do so in order to enable adequate time for an assessment of the legality of the Decision authorising enhanced cooperation. This is particularly important if the proposal for substantive legislation implementing enhanced cooperation is materially different to the original deadlocked proposal. In the event that attempts to use enhanced cooperation become more frequent, the Commission must ensure that authorisation of the procedure is not interpreted as a licence for bringing forward unnecessarily contentious proposals, thereby forsaking a properly balanced approach.**

The opinion of the Council Legal Service

31. The Council Legal Service concluded that the deemed establishment principle[43] does not comply with the Treaty requirements for enhanced cooperation on the following grounds:

- It would exceed the norms of customary international law in respect of extraterritorial taxation, which form part of EU law. This is because there would be insufficient connection between the taxpayer and the Member State imposing the tax when looked at in the light of the objectives of the proposal. The 'escape clause', designed to eliminate situations where there was insufficient link between the economic substance of the transaction and the territory of a participating Member State, is described by the Council Legal Service as "totally unsatisfactory for purpose" because it is too vague and uncertain.
- It could discriminate (in a way which impacts on capital movements) to the detriment of parties caught by the deemed establishment principle. The FTT imposed on such parties is set at the rate determined by, and is payable to, the participating Member State. In contrast, where both parties to a transaction are resident in a participating Member State, they each bear the FTT at the rate set by their own Member State and the tax is payable to their respective Member States. Furthermore the provisions on joint and several liability are more likely to be invoked where transactions involve institutions deemed to be established in a participating Member State.
- It would fail to respect the competence of non-participating Member States as the FTT would be imposed on institutions resident in their territory by and to the benefit of the participating Member State—despite the fact that the primary competence to tax lies with the non-participating Member State.
- It would distort competition because it would be easier to collect tax from institutions established in non-participating Member States, which are subject to the EU regime of mutual assistance and recovery of tax, than it would be from institutions established in third countries.
- It would inhibit the free movement of capital because transactions with counterparties established in non-participating Member States or (even more so) third countries would be less attractive, due to legal uncertainty and the potential for dispute with the tax authority of the participating Member State.[44]

32. In reaction to this opinion, Mr Zourek took a narrow view of the possible impact of the Commission proposal on non-participating Member States. In seeking to justify Mr Bergmann's categorical statement to us,[45] he asserted that there was no impact on the competence of these Member States because they would not be formally bound by the proposal and would remain free to introduce, retain or withdraw their existing or planned FTT.[46] He drew a

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43 Article 4 (1)(f) of the proposal.

44 The Treaty rules on free movement of capital apply, with some modification, to the movement of capital between Member States and third countries.

45 See above, para 15.

46 2 October 2013 evidence session, *Op. Cit.*, Q 2.

distinction between the impact on a country and an impact on undertakings.[47] The Commission considered that there was a sufficient connection, via the party to a transaction established in a participating Member State, to justify extraterritorial taxation, and that issues of collection of the FTT (as opposed to imposing it) had been left open by the proposal.[48] Mr Zourek considered that there was no discrimination because institutions established in a participating Member State could not be considered to be in the same position as ones established in a non-participating Member State. In his view, the differential effect of the FTT was the inevitable consequence of a tax being introduced in one jurisdiction but not in another.[49]

33. When considering the effect on the market of the issuance principle, Mr Zourek thought that there would be a financial incentive for stock exchanges in third countries, such as the USA, trading in products issued in a participating Member State to collect the FTT as they would either be paid a fee for doing so, or would retain the interest on the tax collected before it was accounted to the participating Member State. The tax authority of the participating Member State would either have to offer a financial incentive or accept that companies would seek to issue their shares away from the FTT zone. He claimed, however, that this was a consideration for the Member States who requested the Commission to bring forward this proposal.[50] **We continue to believe that the proposal risks driving transactions offshore, and we do not think that there is any financial incentive that could realistically be paid to authorities in New York, Singapore or Hong Kong which would lead them to welcome the extraterritorial taxation of transactions in their jurisdictions. We are equally sceptical about the Commission's claim that the tax would generate revenue of €31 billion per annum.**

34. In a letter dated 31 October 2013, Commission Vice-President Maroš Šefčovič provided a substantive response to the points raised with the Commission by the Committee.[51] As a general point he indicated that the issues raised by the Committee were currently central to the discussion of the proposal at a technical level in the Council.

35. Mr Šefčovič generally repeated the approach taken by Mr Zourek. He asserted that the Commission considered that the proposal would provide sufficient connecting factors with the territory of the participating Member States to justify extraterritorial taxation; and that the proposal would respect the competences, rights and obligations of non-participating Member States. However he did not provide a detailed refutation of the objections raised by the Council Legal Service.

36. Mr Šefčovič also repeated the distinction raised by Mr Zourek between the imposition and the collection of the FTT. Collection was considered primarily a matter of Member State competence, although the Commission was reflecting on appropriate collecting mechanisms, possibly using exchanges and clearing houses although in the absence of bilateral or multilateral agreement those outside the FTT zone could only be involved

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47 *Ibid.*, Q 3.

48 *Ibid.*

49 *Ibid.*, QQ 7–9.

50 *Ibid.*, Q 10.

51 Letter from Vice-President Šefčovič to Lord Boswell, 31 October 2013, *Op. Cit.*

on a voluntary basis. He indicated that the provision on joint and several liability was a "safety measure" to ensure that parties only dealt with compliant counterparties.

37. Finally Mr Šefčovič did address the effect of the EU mutual recovery regime and expressly recognised that non-participating Member States would be obliged to operate this. He accepted that this may result in the authorities of a non-participating Member State being requested to recover tax under this regime incurring additional expenditure. However he considered that this would only be a minor consideration, that it was properly considered to be a consequence primarily of the operation of the mutual recovery regime rather than the FTT proposal, and that it could be offset by the costs recovered from the taxpayer which a requested Member State was entitled to retain. This is not a point raised by the Council Legal Service and is not central to our objections to the FTT.

38. **We find the Council Legal Service opinion highly persuasive. It demonstrates in concrete terms how the proposal would breach EU law. In our view, the evidence we have received from the Commission fails to refute the central objections to the proposal. In significant areas the Commission relies on assertions which are not backed by the detailed reasoning which the Council Legal Service opinion calls for. We consider that the Commission has adopted an unwarrantedly narrow approach. The proposal would clearly have a significant adverse impact on financial institutions established in non-participating Member States by making them liable for the FTT under either the deemed establishment or issuance principles. It cannot credibly be claimed that collection of the FTT is separate from its imposition, and therefore a matter primarily left for the Member States, when collection via joint and several liability is a key feature of the proposal, and the binding EU regime for mutual assistance and recovery is its essential context.**

39. **We make this report to the House for debate.**

APPENDIX : EU SUB-COMMITTEE ON ECONOMIC AND FINANCIAL AFFAIRS

The members of the Sub-Committee who conducted this inquiry were:

Viscount Brookeborough
Earl of Caithness
Lord Carter of Coles
Lord Davies of Stamford
Lord Dear
Lord Flight
Lord Hamilton of Epsom
Lord Harrison (Chairman)
Lord Kerr of Kinlochard
Baroness Maddock
Lord Marlesford
Lord Vallance of Tummel

Declaration of Interests

Viscount Brookeborough
Holds shares in EU registered companies

Earl of Caithness
Holds shares in EU registered companies

Lord Carter of Coles
Farmer in receipt of payments under CAP
Director Primary Insurance Group Ltd
Director UK General Insurance Group Ltd
Holds shares in EU registered companies

Lord Davies of Stamford
Holds shares in EU registered companies

Lord Dear
Holds shares in EU registered companies

Lord Flight
Chairman, Aurora Investment Trust plc (investing primarily in equities mainly listed on the London Stock Exchange)
Chairman, CIM Investment Management Limited (emerging markets investment manager)
Chairman, Downing Structured Opportunities VCT1 plc (venture capital trust)
Director, Edge Performance VCT plc (investing in the entertainment/media sectors)
Director, Flight & Barr Limited
Chairman, Flight & Partners Limited (manager, private equity fund)
Director, Gulf Overseas Investment Fund Limited
Director, Investec Asset Management Limited (international investment manager)
Director, Metro Bank plc (retail bank)
Director, Marechale Capital (corporate finance house)
Commissioner, Guernsey Financial Services Commission (regulator)
Consultant, Kinetic Partners (investment management industry consultants)
Trustee, IAM Pension Fund (Investec Asset Management)

Consultant, Tax Incentivised Savings Association (TISA) (representative body for retail investment management industry). As Consultant, public affairs advice is provided to TISA.
Chairman, EIS Association (representative body for lawyers, accountants, promoters of Enterprise Investment Scheme qualifying companies). As Chairman, public affairs advice is provided to the Association.
Member Investment Committee, Guinness Renewable Energy EIS Fund
From time to time holds shares in EU registered companies

Lord Hamilton of Epsom
Director, Jupiter Dividend and Growth Trust PLC
IREF Global Holdings (Bermuda) Ltd
IREF Australian Holdings (Bermuda) Ltd
AREF Holdings (Bermuda) Ltd
Holds shares in EU registered companies

Lord Harrison (Chairman)
None relevant

Lord Kerr of Kinlochard
Deputy Chairman, Scottish Power plc
Director, Rio Tinto
Director, Scottish American Investment Co Ltd
Member, International Advisory Board, Edinburgh Partners
Chairman, Centre for European Reform
Vice President, European Policy Centre
Holds shares (in Scottish Power, Iberdrola, Rio Tinto, Royal Dutch Shell, European Investment Trust and Scottish American) which would be affected by an FTT as proposed.

Baroness Maddock
None relevant

Lord Marlesford
Independent National Director, Times Newspapers Holdings Ltd
Non-executive Director, Gavekal Research (Hong Kong)
Advisor to Sit Investment Associates Minneapolis
As a farmer—payments are received through the EU CAP

Lord Vallance of Tummel
Member, Supervisory Board, Siemens AG
Member, International Advisory Board, Allianz SE
Chairman, Amsphere Ltd
Holds shares in EU registered companies

The following Members of the European Union Committee attended the meeting at which the report was approved: Lord Boswell (Chairman), Lord Bowness, Lord Carter of Coles, Lord Dear, Lord Foulkes of Cumnock, Lord Hannay of Chiswick, Lord Harrison, Lord Maclennan of Rogart, Lord Marlesford, Baroness O'Cathain, Baroness Parminter, The Earl of Sandwich, Lord Tomlinson, Lord Tugendhat, Lord Wilson of Tillyorn. As Chairman of the Committee, Lord Boswell declared that he holds shares in EU registered companies.

A full list of registered interests of Members of the House of Lords can be found at http://www.parliament.uk/mps-lords-and-offices/standards-and-interests/register-of-lords-interests/