EUROPEAN COMMISSION

Brussels, 10.4.2014
C(2014) 2271 final

Dear Chairman,

The Commission would like to thank the House of Lords for its letter of 10 December 2013 by which it transmitted the report of the EU Committee of the House of Lords entitled "Financial Transaction Tax: Alive and deadly". This report concerns the Commission Proposal {COM (2013) 71} for a Council Directive implementing Enhanced Cooperation in the area of Financial Transaction Tax (FTT), hereafter referred to as "the Proposal".

This letter replies to the letter of 10 December 2013 and is a continuation of the political dialogue on the important issue of FTT. Therefore, the Commission would first of all refer to its previous evidence and written replies given to the House of Lords without going into the details of all elements presented. Neither will the Commission comment on the information presented in the boxes in the above-mentioned report. The Commission would however like to stress the following issues.

Opinion of the Council Legal Service on the "counter-party principle"

With regard to the Opinion of the Council Legal Service on the legality of the counter-party principle laid down in Article 4(1)(f) of the Proposal, the Commission continues to consider this principle to be in conformity both with customary international law and EU primary law.

The House of Lords bases its criticism on the Proposal to a very large extent on the arguments of the Council Legal Service, which the Commission does not share. Therefore, the following part of this reply will focus on these arguments in more detail in order to demonstrate that the Proposal is legally sound.

First, the "counterparty principle" enshrined in Article 4(1)(f) of the Proposal respects the generally accepted requirements of international law concerning the existence and exercise of tax jurisdiction and does not lead to any inadmissible extraterritorial effects of the FTT.

In this respect it must be stressed that, as far as the Council Legal Service's assertion is concerned that a State has no tax competence in circumstances where another State has a "more relevant interest", there is in the Commission's view no such principle in public

Lord Boswell
Chairman of the European
Union Select Committee
House of Lords
Palace of Westminster
UK – LONDON SW1A 0PW

international law generally or in the law relating to tax competence in particular. Instead, the sole relevant criterion for the determination of tax jurisdiction is the connection between a State and the person or transaction it wishes to subject to taxation. There must, therefore, be either a personal or an objective "nexus" between the taxpayer and the State concerned.

The establishment requirements as formulated in the individual rules of Article 4(1)(a) to (e) of the Proposal make sure that in each case where the "residence principle" applies there would be not only a connection of the financial institutions with the territory of the participating Member State, but also a "nexus" of the relevant financial transaction as such with that State. This holds irrespective of where the other party to that transaction is established.

The "counterparty principle" under Article 4(1)(f) of the Proposal, on the other hand, addresses financial institutions that are not (deemed to be) established in the territory of a participating Member State under Article 4(1)(a) to (e). In order for such a financial institution (located either in a non-participating Member State or in a third country) to be liable for FTT, it must participate in a financial transaction with a counterparty that is specifically connected with a participating Member State: that counterparty must either be "a financial institution established in that Member State" pursuant to Article 4(1)(a) to (e), or "a party ... which is not a financial institution" but is nevertheless "established in the territory of that Member State" pursuant to the criteria in Article 4(2).

Thus, Article 4(1)(f) only applies if the financial institution's counterparty is (deemed to be) established in a participating Member State. This rule would not create tax jurisdiction where it would not otherwise exist. It would simply determine who is liable for tax on a transaction which in any event falls within the tax jurisdiction of that participating Member State: Where the counterparty is another financial institution, the provisions in Article 4(1)(a) to (e) ensure that its financial transactions have a sufficiently close "nexus" with the territory of a certain participating Member State to grant that State tax jurisdiction. The same is true where the counterparty is a person that is not a financial institution, since the criteria in Article 4(2) likewise would ensure a sufficiently close "nexus" between the relevant financial transactions and the territory of a participating Member State.

Hence, in all the situations of cross-border financial transactions addressed by Article 4(1)(f) the financial institution concerned (located either in a non-participating Member State or in a third country) takes part in a financial transaction comprising a mutual exchange of values with a counterparty established in a participating Member State, thereby contributing to the achievement of a legally relevant result within the State of that counterparty. For the same reason the financial institution is connected with the territory of that participating Member State through the object of the tax ("economic attachment"). Through its voluntary participation in such a financial transaction with a counterparty established in a participating Member State, the financial institution concerned subjects both the transaction and itself to the tax jurisdiction of that Member State.

In this context the function of Article 4(1)(f) would not only be to answer the question "which State is entitled to levy FTT" on a financial transaction, but also to provide an answer to a *different, though equally pertinent question, namely "who is obliged to pay FTT" if it is due. In this regard, the rule would ensure the existence of a link between the transaction that is subject to the above mentioned tax jurisdiction of a participating Member State on the one hand and, on the other, a given person, who is thus equally subject to this tax jurisdiction. Or to put it differently, the transaction is linked with the territory of the participating Member State through the counterparty, and through the transaction as such also the financial institution addressed by Article 4(1)(f) has a relevant territorial connection with that State.*

As regards the "escape clause" laid down in Article 4(3) of the Proposal, the Commission does not agree that an application of this rule by Member States "would foremost create considerable risk for litigation before the Court of Justice and ensuing legal insecurity". The function of this provision would be to ensure that in the rare situation in which a financial transaction is captured by the criteria set forth in Article 4(1) but in reality lacks any sufficient nexus with the territory of the Member States concerned can be excluded from the tax met. The Commission does not consider that the true location of the economic substance of a transaction is likely to give rise to significant uncertainty, and considers that any disputes could be resolved.

Furthermore, the Commission finds that the proposed Article 4(1)(f) fully respects the competences, rights and obligations of Member States not participating in the enhanced cooperation on FTT and therefore it is compatible with Article 327 TFEU.

The provision would neither have an impact on the freedom of non-participating Member States to exercise their own tax competence in whatever manner they see fit, nor would it lead to an application of FTT as such in the territories of non-participating Member States. As has been explained above, Article 4(1) as a whole is based on the "nexus" between a given financial transaction and the territory of one of the participating Member States, and the specific rule in Article 4(1)(f) would be triggered only where such a "nexus" exists and a participating Member State thus has tax jurisdiction over the financial transaction in question.

It is true that the application of Article 4(1)(f) may lead to a situation where one and the same transaction would not only be subject to the proposed harmonised FTT in a participating Member State, but also to a financial transaction tax levied by a non-participating Member State. This, however, would be nothing other than the phenomenon that occurs in all cases where cross-border activities are simultaneously confronted with the legal systems of different States, namely "dual regulation" which, in the present context, takes the form of international double taxation. Customary international law does not prevent the overlap of different national tax jurisdictions and, as the CJEU has consistently held, neither does EU primary law prohibit double taxation by two different Member States.

The Commission would like to point out that its FTT proposal is actually striving to achieve the elimination of double taxation by different national financial transaction taxes. The Commission is proposing a measure based on Article 113 TFEU in order "to ensure the establishment and the functioning of the internal market and to avoid distortion of competition" by harmonising Member States' rules on taxes on financial transactions. Such *harmonisation necessarily requires clear rules on the allocation of taxing rights, and it would achieve its best effect if all Member States would participate. However, the fact that the current Proposal is dealt with under enhanced cooperation, so that those rules on the allocation of taxing rights do not apply to all 28 Member States, would not affect the competences, rights or obligations of non-participating Member States and would thus not be incompatible with Article 327 TFEU. Even with a participation of only 11 Member States, any remaining effects of double taxation occurring in the relationship with non-participating Member States would simply be the consequence of a parallel exercise of tax competence. Such exercise by participating Member States would be no more incompatible with public international law than the parallel exercise by non-participating Member States, or indeed third countries.*

Finally, Article 4(1)(f) of the Proposal is in the Commission's view also perfectly in line with other rules of EU primary law, in particular with Article 326 TFEU governing enhanced cooperation and with the fundamental freedoms. In particular, the rule would not give rise to discrimination among financial institutions nor to distortion of competition between such institutions in the EU, since it merely concerns the allocation of taxing powers. What is perceived as discrimination here is in reality nothing but a disparity between different national tax regimes.

In this respect, a first element of alleged unlawful discrimination concerns the fact that Article 4(1)(f) would apply only to financial institutions that are not (deemed to be) established in a participating Member State. It is true that if a financial institution (deemed to be) established in a participating Member State engages in a transaction with a financial institution resident in a non-participating Member State, the former Member State would be entitled to two payments of FTT (one from each institution, under Article 4(1)(a) to (e) and Article 4(1)(f), respectively), whereas for a transaction between the first-mentioned financial institution and an institution from another participating Member States the Member State of that first institution would only be entitled to one FTT payment (under Article 4(1)(a) to (e)). However, in the latter situation there would also be an FTT claim in the other participating Member State against the other financial institution which is (deemed to be) established there (likewise under Article 4(1)(a) to (e)). So in both situations there would be two FTT claims, and the only distinction between them is that in a transaction between two participating Member States there would be a mechanism for the allocation of taxing rights. As already explained above, the absence of such a mechanism in relations with non-participating Member States cannot be regarded as discrimination.

A second element that is claimed to be discriminatory is the fact that a financial institution (deemed to be) established in a participating Member State would always be subject to that State's FTT rate, while a non-established financial institution could face a range of 11 different FTT rates in the various participating Member States (as Article 9(2) of the Commission's Proposal only provides for minimum tax rates). However, these are mere disparities between the different national regimes which will always exist as long as not all tax systems of all Member States are fully harmonised. In this respect, too, the case-law of the CJEU leaves no doubt that these objective divergences between the legislation of different Member States do not constitute an infringement of the fundamental freedoms.

And thirdly, as regards the potentially higher risk run by counterparties (deemed to be) established in a participating Member State to be subject to joint and several liability (Article 10(2) of the Proposal) when engaging in financial transactions with financial institutions located outside the 11 participating Member States, it must be pointed out that the CJEU, in various judgments on the Treaty freedoms, has accepted that the legislation of a Member State, in order to be sufficiently effective in cross-border situations, may install specific procedural measures. In particular, the Court has recognised that the difficulties to recover taxes abroad in the hands of non-resident taxpayers allow a Member State to have recourse to a resident counterparty in the relevant contractual relations, and to subject that counterparty to specific tax obligations such as, e.g., to withholding tax at source and being liable for that tax. This possibility for Member States exists all the more in relation to third countries.

Regarding the alleged distortions of competition (namely in relation between financial institutions located in non-participating Member States and those located in third countries) due to a lack of instruments for mutual assistance between national tax authorities, it must be pointed out that any such effects lie outside the scope of Article 326 TFEU, which is exclusively concerned with "trade between Member States" and "competition between them". For the rest, they are inherent in the absence of appropriate agreements with the third countries concerned. Since they do not reflect any violation of fundamental freedoms, they cannot be criticised from an EU law perspective. It may be added that if the contested theory were correct it would entail the invalidity of Directive 2011/16/EU on administrative cooperation in the field of taxation, since it would entail, for example, discrimination in the enforcement of Member States' legislation on corporation tax.

Last but not least, if it were true that the FTT "as such" would create an "obstacle to the free movement" of capital (and/or services), every single tax that affects cross-border activities would, by virtue of its mere existence, constitute an obstacle to free movement. Such a thesis cannot be maintained. In reality, the fact that FTT would only exist in a harmonised form in the 11 participating Member States, but not outside that FTT area, is merely a disparity which is neutral from the perspective of the Treaty freedoms.

The enhanced cooperation procedure

The House of Lords specifically invites the Commission to comment on the House of Lords' position with regard to the enhanced cooperation procedure. In this respect, the Commission would like to stress that under enhanced cooperation as provided for in the Treaties, the authorisation and implementation thereof are two different steps in the procedure.

In its proposal for a Council Decision authorising enhanced cooperation in the area of FTT, the Commission assessed that all relevant Treaty conditions for enhanced cooperation are fulfilled, and the Commission also judged it appropriate to establish enhanced cooperation. Both the Council and the European Parliament agreed.

There is no obligation for the Commission to present the proposal for authorisation and that for implementation at the same time. However, in their requests to the Commission to establish enhanced cooperation, the interested Member States indicated that the scope and *objectives of the enhanced cooperation should be based on the Commission's original proposal for a Directive of 28 September 2011. Reference was also made in particular to the need to avoid evasive actions, distortions and transfers to other jurisdictions. Consequently, all Member States were in a position to have sufficient knowledge of the content of the forthcoming Commission proposal on the implementation of the enhanced cooperation at the time of authorisation. All the more, because the Commission services had presented the basic lines of that forthcoming proposal (based on the original proposal while in essence strengthening anti-avoidance) in the relevant Working Party of the Council before the adoption of the Authorisation Decision.*

The (Implementation) Proposal is currently the subject of scrutiny in the Council Working Party and of the usual negotiation process. All Member States participate in the process. The Commission will cooperate with all of them to ensure that the enhanced cooperation works, to come to viable solutions and to promote the participation in enhanced cooperation by as many Member States as possible. It is however for the participating Member States to unanimously take final conclusions, and non-participating Member States may not impede the implementation of enhanced cooperation by participating Member States.

Finally, it is true that the legislation adopted under enhanced cooperation as provided for in the Treaties only binds participating Member States. It is, moreover, not part of the EU acquis to be accepted by candidate Member States. However, the application of the Directives on administrative cooperation between Member States does not flow from enhanced cooperation but is part of the EU acquis. This aspect is in any event irrelevant for the purposes of Article 332 TFEU: when this provision states that the "[e]xpenditure resulting from implementation of enhanced cooperation ... shall be borne by the participating Member States", the term "expenditure" clearly refers to expenditure incurred by the EU budget only since it is the only expenditure relevant within the context.

Collection of the proposed FTT

In addition to what has been explained in the reply of the Commission of 31 October 2013 and the oral evidence presented on 19 March and 2 October 2013, it should be noted that in the aftermath of the financial crisis, because of budgetary constraints and calls for fair taxation, there is a general tendency on a global scale towards more transparency and international cooperation in tax matters which is also supported by the UK government. Consequently, and apart from the legal arguments mentioned above, whereas administrative cooperation between EU Member States and third countries already exists, the level and amount of international cooperation is constantly increasing. The use of administrative cooperation tools between Member States can thus not be presented as a unique fact, as Member States can increasingly cooperate with third countries.

It is however to be repeated that in the first place straightforward FTT collection mechanisms should be put in place and that furthermore, the administrative cooperation instruments can only be used under the limits and conditions set therein.

Moreover, the "obligatory" joint and several liability provision under the proposed FTT, referred to by the House of Lords, only applies where the financial institution as a person *primarily liable to pay the proposed FTT did not pay that tax within the time limit set. The Commission takes the view that such provision would be an incentive for tax compliance and preservation of sound functioning of financial markets and contractual relation, and it stands ready to assist all Member States in the establishment of the prime and straightforward collection methods mentioned (which can be differentiated according to the type of financial instruments subject to the proposed tax and which will thus also heavily depend on the final design of the tax).*

The Commission hopes that these clarifications address the concerns raised by the House of Lords and looks forward to continuing our political dialogue in the future.

Yours faithfully,

Maroš Šefčovič
Vice-President