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OPINION OF THE LEGAL SERVICE[*]

Subject: Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax (FTT)

- Legality of the counterparty-based deemed establishment of financial institutions (Article 4(1) point f) of the proposal)

I. Introduction

1. In 2011 the Commission presented a proposal for taxation of the financial sector, providing for a harmonised financial transaction tax (FTT) that would apply to transactions by financial institutions with respect to certain financial instruments. Absence of unanimity on the proposal led eleven Member States to initiate proceedings for the establishment of an enhanced cooperation. By Decision 2013/52/EU, the Council authorised on 22 January 2013 enhanced cooperation to go ahead in the area of the financial transaction tax. The proposal under consideration in this opinion was thus submitted by the Commission to the Council in accordance with Council Decision 2013/52/EU authorising enhanced cooperation in the area of the financial transaction tax.

[*] **This document contains legal advice protected under Article 4(2) of Regulation (EC) No 1049/2001 of the European Parliament and of the Council of 30 May 2001 regarding public access to European Parliament, Council and Commission documents, and not released by the Council of the European Union to the public.**

2. In the course of the proceedings in the Working Party on Tax Questions - Indirect Taxation (VAT), doubts were expressed regarding the compatibility of Article 4(1) point f) of the proposal with Article 327 TFEU, equal treatment, proportionality and the principles governing the internal market, in particular the free movement of capital. It was contended that Article 4(1) point f) of the proposed Directive would disrespect fiscal competences of non-participating Member States as there would be an insufficient link between the taxing Member State and the non-resident person liable to pay FTT pursuant to that provision in order to justify the exercise of prescriptive fiscal jurisdiction over that non-resident person. The opinion of the Legal Service was sought on these issues.

3. The present opinion constitutes the answer of the Legal Service to this request. It is not intended to cover other issues or other provisions of the proposal.

4. It is to be noted that the legality of proposed rules of secondary Union law to be adopted in the framework of an enhanced cooperation is to be examined at the same time under the general rules and principles of the Treaty on European Union and the Treaty on the Functioning of the European Union, including the obligation to respect customary international law (Article 3(5) TEU), and under the specific rules established by the Treaty on the Functioning of the European Union with respect to the establishment of enhanced cooperation, in particular Article 327 TFEU, which requires that "*any enhanced cooperation shall respect the competences, rights and obligations of those Member States which do not participate in it. (…)*" and Article 20(4) TEU which establishes that "*acts adopted in the framework of enhanced cooperation shall bind only participating Member States*.".

II. Relevant elements of the proposed Directive

5. Under Articles 1, 3 and 5 of the Proposal, participating Member States shall charge FTT for each financial transaction (as defined in the Proposal) on the condition that at least one party to the transaction is established in the territory of the participating Member State and that a financial institution established in the territory of a participating Member State is party to the transaction, acting either for its own account or for the account of another person, or is acting in the name of a party to the transaction.

6. Financial institutions in the Proposal are widely defined and include credit institutions, regulated markets, insurance and reinsurance undertakings, pension funds, most retail and private funds, special purpose vehicles, and any other undertaking, institution, body or person carrying out activities defined in the Proposal in case the average annual value of its financial transactions constitutes more than fifty per cent of their overall average net annual turnover

7. Under Article 10, FTT shall be payable in respect of each financial transaction by each financial institution which is a party to the transaction, to the tax authorities of the participating Member State in the territory of which the financial institution is deemed to be established. The taxable amount shall be everything which constitutes consideration paid or owed, in return for the transfer, from the counterparty or a third party (Article 6) or the notional amount referred to in the derivatives contract (Article 7), and where the tax has not been paid, each party to the transaction shall be jointly and severally liable for the payment of the tax due.

8. In the terms of Article 4 of the Proposal, a financial institution shall be deemed to be established in the territory of a participating Member State if

   (a) it has been authorised by the authorities of that Member State to act as such, in respect of transactions covered by that authorisation;

   (b) it is authorised or otherwise entitled to operate, from abroad, as financial institution in regard to the territory of that Member State, in respect of transactions covered by such authorisation or entitlement;

   (c) it has its registered seat within that Member State;

   (d) its permanent address or, if no permanent address can be ascertained, its usual residence is located in that Member State;

   (e) it has a branch within that Member State in respect of transactions carried out by that branch;

   (f) it is party, acting either for its own account or for the account of another person, or is acting in the name of a party to the transaction, to a financial transaction with another financial institution established in that Member State pursuant to points (a), (b), (c), (d) or (e), or with a party established in the territory of that Member State and which is not a financial institution;

(g) it is party, acting either for its own account or for the account of another person, or is acting in the name of a party to the transaction, to a financial transaction in a structured product or one of the financial instruments referred to in Section C of Annex I of Directive 2004/39/EC issued within the territory of that Member State, with the exception of instruments referred to in points (4) to (10) of that Section which are not traded on an organised platform.

9. Where more than one of the factors above is fulfilled, it is the first factor fulfilled from the start of the list in descending order that is relevant for determining the participating Member State of deemed establishment (Article 4(4)).

10. In the light of the above, the connecting factors for levying FTT under the Proposal can be resumed to be :

- "authorisation" of the financial activity in respect of which the taxable transaction is carried out by the financial institution (place of transaction) (Article 4(1), points a) and b));
- establishment (residence or branch that carries out the transaction) of the financial institution in the taxing Member State (Article 4(1), points c), d) and e));
- establishment or "authorisation" of the financial institutions' counterparty in the taxing Member State (hereafter "counterparty" principle or "counterparty" factor) (Article 4(1), point f));
- issuance of the financial instrument in the taxing Member State (Article 4(1), point e)).

11. The connecting factor for taxation of financial transactions concluded by financial institutions that are resident in a participating Member State is their residence, whether or not they engage in cross-border transactions and whether or not their cross-border transactions are with a counterparty in another participating Member State. The connecting factor is however the residence of the counterparty for financial transactions concluded by a financial institution resident in a non participating Member State.

12. As a result of the "deemed establishment" (in the Member State of their counterparty) of financial institutions that are resident in a non participating Member State ("counterparty principle"), and the non-taxation of financial institutions resident in a participating Member State by the participating Member State of their counterparty when those financial institutions engage in cross-border transactions, the global amount of FTT to be paid on a financial transaction remains the same whether a financial transaction is between two financial institutions resident in the same participating Member State, or whether it is between two financial institutions resident in different participating Member States, or whether it is between a financial institution resident in a participating Member State and a financial institution resident in a non participating Member State. The actual place of establishment of a financial institution (within or outside the FTT-zone) has no bearing on the global amount of tax collected in the end.

13. This result is obtained in the Proposal by generating an obligation to pay for financial institutions that are actually established in a State to which the proposed Directive does not apply and by making the institution actually established in a participating Member State liable for payment of the sums due by its "deemed established" counterparty.

14. In the words of the Commission's explanatory memorandum, *"In case the different financial institutions […] are established in the territory of different participating Member States […], each of these different Member States will be competent to subject the transaction to tax at the rates it has set in accordance with this proposal. Where the establishments concerned are located in the territory of a State which is not a participating Member State, the transaction is not subject to FTT in a participating Member State, unless one of the parties to the transaction is established in a participating Member State in which case the financial institution which is not established in a participating Member State will also be deemed to be established in that participating Member State and the transaction becomes taxable there"*.

15. The "deemed" establishment in the territory of participating Member States of institutions which, for all purposes other than those of the proposed Directive, are established in other States, including Member States of the Union which do not participate in the enhanced cooperation, constitutes a construction that departs from the ordinary meaning of establishment, as the explanatory memorandum plainly admits by stating that *"the financial institution which is not established […] will also be deemed to be established"*.

III. Legality of Article 4(1) point f) of the Commission Proposal

16. The notion of establishment is not one that is purely defined by lexical convention but is the subject of legal definition based on Articles 49 to 55 TFEU dealing with the right of establishment. There is no need to dwell on the fact that an undertaking which enters into a transaction with another undertaking established in a Member State does not become established in that Member State in the legal sense of the word as interpreted by the EU case-law.

17. Admittedly, it is the substance and not the wording which matters and tax provisions may have recourse to a special terminology, different from the general meaning of words, to the extent such a difference is justified by the nature and the purpose of the measure concerned. But, in the present case, Article 4(1) point f) of the proposed Directive, concerning the deemed establishment based on the counterparty principle, raises issues of extraterritorial exercise of jurisdiction, disrespect of non participating Member States' rights under the Treaty, and compatibility with the principles of free movement of capital and non discrimination.

(i) jurisdiction to tax - extraterritorial effect of Article 4 of the proposed Directive

18. The imposition of FTT on financial institutions resident in non participating Member States pursuant to the "counterparty" principle in Article 4(1), point f) of the proposed Directive, would constitute the exercise of jurisdiction over entities located outside the geographical area concerned by the legislation adopted under the enhanced cooperation.

19. Under customary international law, which in accordance with Article 3(5) TEU is to be respected by the Union,[1] jurisdiction is based on the existence of a relevant link between the State that exercises jurisdiction and the person or situation over which jurisdiction is exercised. Whether there is sufficient nexus to justify the exercise of taxing jurisdiction by participating Member States in respect of the financial transactions covered by Article 4(1) point f), and whether other States have not a more relevant interest in regulating the taxpayer's conduct, is to be determined also in the light of the objectives pursued by the proposed legislation for a FTT, which are: the raising of revenue, contribution by the financial sector to the costs of the crisis, and dis-incentivising excessively risky activities.

20. It goes without saying that the raising of revenue by a Member State does not justify recourse to a remote nexus for taxation of foreign based persons thereby impinging on more relevant tax jurisdiction of other States over those persons or the activity involved.

21. Also the objective to have the financial sector contribute to the costs of the crisis, is not liable to justify the scope of the taxing jurisdiction that would be exercised pursuant to Article 4(1), point f). A substantive part of the financial institutions and of the types of transactions that would be taxed under that provision have had no part whatsoever in the crisis and are not liable to contribute to any crisis in the future, and if they had to contribute to any costs related to the crisis, the Member State or third country in which they are established would be better entitled to claim such contribution.

22. Thirdly, as concerns the objective to reduce risks in the financial market, the FTT proposed will be levied not only on risky activities but to a large extent also on activities with a genuine economic substance that are not liable to contribute to systemic risk and which are indispensable for the activities of non-financial business entities. Where activities are covered that can indeed be considered to be liable to contribute to financial markets' risk, it has not been demonstrated that the interests of Member States' are endangered to a point that the Union should divert from its attitude in principle of restraint as to extraterritorial exercise of jurisdiction.

[1] See Judgment of the Court of Justice of 21 December 2011 in Case C-366/10.

23. It is finally hardly necessary to add that it cannot reasonably be argued that there is an overwhelming necessity to make financial institutions established outside the FTT-jurisdiction liable for FTT on their transactions with counterparties resident or otherwise established in that jurisdiction in order to fight fraud or tax evasion. The concern that the introduction of a FTT will cause migration of financial transactions to non-participating States does not justify in itself extraterritorial tax legislation. To regard any transaction of a financial institution resident in the FTT-jurisdiction as an act justifying, by definition, anti-fraud or anti-evasion measures would not be in compliance with the proportionality principle.

24. In the Legal Service's opinion, the exercise of taxing jurisdiction in accordance with Article 4(1), point f) of the proposed Directive does not stand the test of territorial connection that the Union has defended, in particular, in the case of the Helms-Burton legislation, and exceeds the Union's legislative jurisdiction, starting from the basic predicament that entities "must be subject to the laws of the country where they are located" and that exceptions are essentially linked with situations where the activities of the entity are largely directed, as in the *Wood Pulp* case,[2] towards another territory. The automatic character of the implementation of the provision under discussion does not leave room for a consideration of the latter criterion.

25. In the light of the foregoing it is not necessary to dwell on the "escape clause" in Article 4(3) of the Proposal, designed to eliminate situations with insufficient nexus. The provision is at all events totally unsatisfactory for that purpose. It is indeed at Union level, in the Directive, that rules must be established capable of ensuring justified and proportionate exercise of taxing jurisdiction by participating Member States, not at the level of the implementation of the Directive by Member States. Not only is it quite impossible for individual Member States to define situations where an economic link would be lacking without a risk of creating disparity of application of the Directive within the FTT jurisdiction and unravelling the underlying logic of Article 4. But it would foremost create considerable risk for litigation before the Court of Justice and ensuing legal insecurity, to have Member States decide on the delimitation of mandatory rules of secondary law.

[2] Judgment of the ECJ of 31 March 1993 in joined cases C-89/85 and others, ECR 1993, Page I-01307.

(ii) different treatment of resident and non-resident financial institutions as to the connecting factors applied

26. The proposed Directive applies the "counterparty" factor in a discriminatory manner. It is indeed applied only to transactions involving financial institutions that are not resident in a participating State, and leaves untaxed in the counterparty State transactions concluded by financial institutions that are residents of participating Member States.

27. Indeed, pursuant to Article 4 of the proposed Directive, a participating Member State (MS A)

- taxes its own financial institutions (financial institutions authorised by it, or having their residence in its territory) with respect to all their transactions worldwide;
- taxes financial institutions that are resident in a non participating Member State or third country[3] with respect to any financial transaction concluded with a counterparty that is established in its territory;
- to the contrary does not tax financial institutions that are resident in another participating Member State (MS B) with respect to financial transactions concluded with a counterparty that is established in its territory.

28. In other words, in situations that are identical from a territorial point of view, transactions by non resident financial institutions are treated differently depending on whether the financial institution is established in another participating Member State (in that case the financial institution is not liable for FTT to the participating Member State of its counterparty) or in a country that does not participate in enhanced cooperation (in that case the financial institution is liable for FTT to the participating Member State of its counterparty). And in an identical situation, participating Member States impinge on non participating Member States rights to tax but not on those of other participating Member States.

[3] And have no branch in a participating Member State carrying out the transaction.

29. It is as a result of that different treatment that, as delegations have correctly observed, a participating Member State will receive FTT twice when a transaction is between a resident financial institution and a financial institution that is not established in a participating Member State, but only once when the transaction is between a resident financial institution and a financial institution resident in another participating Member State.

30. The different connecting factors applied exclude double taxation in cross-border situations within the FTT-zone, whilst no provision is made in the proposed Directive for double tax relief (on a reciprocity basis) with respect to financial transactions with residents of non participating Member States. Not providing for double tax relief exposes financial institutions from non participating Member States and third countries to higher costs than those imposed by the proposed directive on financial institutions resident in participating Member States and is thus capable of entailing a distortion of capital movements.

31. Furthermore, the different allocation of taxing powers entails discrimination of financial institutions in non participating States as to applicable FTT rates in the event that participating Member States would apply different rates. Whilst financial institutions resident in the FTT jurisdiction would always be liable for FTT at the rate of the Member State of their residence, financial institutions not established in the FTT jurisdiction would in principle need to pay FTT at the rate set by the participating Member State of their counterparty. The difference in treatment is again liable to create distortions of competition. It is to be noted in this respect, that the situation is different from that in the area of VAT, where any difference in rates to the disadvantage of given taxable persons is in general imputable to the latters' country of establishment.

32. Finally, the different allocation of taxing powers is discriminatory as residents of a participating Member State (whether or not financial institutions) incur less risk of being held liable for the payment of FTT on the basis of the joint and several liability foreseen in Article 10(2) of the proposed Directive when acting with a counterparty that is a financial institution resident in a participating Member State than with a counterparty that is a financial institution that is not a resident of a participating Member State. A financial institution that is a resident of a participating Member State is liable for FTT to that very Member State and it is unlikely that the latter could not enforce payment of FTT on that institution and would need to resort to joint and several liability of the counterparty. The difference in treatment as to the connecting factor for liability for FTT might therefore also for that reason have an impact on capital movements within the Union and between the Union and third countries.

(iii) the protected rights of non participating Member States - Article 327 TFEU

33. Under Article 327 TFEU, *"any enhanced cooperation shall respect the competences, rights and obligations of those Member States which do not participate in it. Those Member States shall not impede its implementation by the participating Member States."*.

34. Where extraterritoriality defines the system in the proposed Directive in terms of international law, it is Article 327 TFEU (that encompasses respect of international public law) that frames the relations between Member States of the Union participating in enhanced cooperation and non participating Member States, and that is the reference for delimiting jurisdiction exercised in the framework of enhanced cooperation.

35. By virtue of Article 327 TFEU, the competences, rights and obligations of non participating Member States must be respected by any enhanced cooperation. This entails the protection of the right of non participating Member States to maintain or adopt their own tax system, while respecting Union law of general application but without being made subject to an obligation to amend or complement their national rules in order to make them compatible with provisions adopted in the framework of an enhanced cooperation to which they are not a party.

36. With respect to the financial transaction tax proposed by the Commission in 2011, a number of Member States have, for policy reasons, decided not to exercise their taxing competence with respect to the activities of financial institutions established in their territory. In accordance with that choice, they are not participating in the implementation of the enhanced cooperation in the field of FTT. Other Member States choose to introduce a FTT amongst themselves by way of enhanced cooperation under the Treaty. Amongst themselves, the latter have resolved the issue of possible concurring taxing powers with respect to cross-border transactions - and possible resulting double taxation - by an allocation of taxing powers whereby taxing powers rest exclusively with the Member State of residence. With respect to transactions between financial institutions resident in non participating Member States and persons established in participating Member States however, taxing powers of participating Member States would not rest with the Member State of residence of the financial transaction but with the Member State of the counterparty. In that sense, in spite of some Member States not participating in the enhanced cooperation, the FTT would be applied in their territories, although just to some of the transactions which are subject to the tax in the participating Member States, as the tax would be levied on financial institutions established in the non participating Member States. Regardless of the decision of these Member States not to participate in the enhanced cooperation, their financial markets would be burdened with the tax.

37. Indeed, whilst non participating Member States may apply, and whilst some do apply, a non harmonised national tax on financial transactions, and whilst on the face of it mutual relief for double taxation would put participating and non participating Member States on an equal footing, it is undeniable that as a consequence of the mere scope of the FTT in the proposal for a Directive as compared to the more modest financial transactions taxes applied by non participating Member States by virtue of non harmonised national tax legislation, double tax relief would still result in the levying of tax by participating Member States with respect to situations that are the primary competence of non participating Member States. Financial transactions concluded by financial institutions in non participating Member States would still in a vast majority of cases contribute to the budget of participating Member States, whilst transactions by financial institutions resident in participating Member States would never contribute to the budget of another Member State.

38. Therefore, the proposed Directive would necessarily affect the legal and financial situation of non participating Member States to an extent that goes far beyond their duty not to impede the implementation of the enhanced cooperation.

(iv) distortion of competition

39. In relations between participating and non participating Member States, the implementation of FTT legislation and the recovery of taxes due are facilitated by the obligations of non participating Member States vis-à-vis participating Member States pursuant to primary and secondary Union legislation. The same facilities do not exist for the implementation of FTT vis-à-vis financial institutions established in third countries. This may result in distortions of competition and of capital movement between financial institutions established in non participating Member States and financial institutions in third countries.

(v) free movement of capital

40. The proposed "counterparty principle" would render less attractive financial transactions with financial institutions located outside the participating Member States, since these institutions, would have to pay the FTT at different rates in different countries and the counterparty may be unwilling to be liable for that tax and to face, on these grounds, legal uncertainty and possible disputes with the authorities of the participating Member State. As such, the tax would have an effect equivalent to that of a duty imposed in return of the possibility to enter into a transaction with an institution located in a participating Member State and would constitute an obstacle to the free movement of capital as well to the freedom to provide services, guaranteed by Articles 56 to 66 TFEU as a fundamental principle of EU Law.

41. The issue of implementation of the legislation to be adopted pursuant to the Directive is relevant in this respect. If legislation imposing fiscal obligations on persons outside the territory of the taxing State cannot be enforced, this is liable to create legal insecurity and to lead to distortion of competition between actors against whom the legislation can be enforced and actors against whom enforcement proves impossible. Where enforcement of FTT within the Union, as a consequence of Member States' obligations to provide mutual assistance, would present less difficulties than implementation with respect to financial institutions in third countries, the ensuing differences in compliance would be liable to have an impact on capital movement.

IV. Conclusion

42. It is the Legal Service's view that the criterion for deemed establishment of an institution which Article 4(1) point f) of the proposed Directive contains:

1. exceeds Member States' jurisdiction for taxation under the norms of international customary law as they are understood by the Union;

2. is not compatible with Article 327 TFEU as it infringes upon the taxing competences of non participating Member States;

3. is discriminatory and likely to lead to distortion of competition to the detriment of non participating Member States.

Other criteria to determine the applicability of the tax regime, be they already present in the proposal or otherwise conceivable, are not the subject of the discussion in this opinion.

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