WHETHER THE PROPOSED EU FINANCIAL TRANSACTION TAX AS APPLIED TO FX FORWARDS, FX SWAPS, FX OPTIONS AND NON-DELIVERABLE FORWARDS CONTRAVENES THE FREE MOVEMENT OF CAPITAL

SUMMARY OF OUR CONCLUSIONS

1. You asked us to deliver an opinion on whether the FTT proposed in the legislative proposal for a Directive (per COM/2013/71) as applied to FX forwards, FX swaps, FX options and FX non-deliverable forwards (together "**FX Products**") contravenes the free movement of capital. This note summarises our conclusions.

2. The free movement of capital is established by Article 63(1) of the Treaty on the Functioning of the European Union ("**TFEU**"), which provides that, subject to certain exceptions:

   > "*Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.*"

3. In our opinion, on the basis of current EU legislation and the case law of the Court of Justice of the European Union ("**CJEU**"):

   (a) the FX Products constitute, or are inextricably linked with, "movements of capital" for the purposes of Article 63 TFEU. The Treaty does not define the term "movement of capital". However, case law of the CJEU has indicated that, for the purposes of defining what constitutes a capital movement, the nomenclature in Annex I of Directive 88/361 retains its "indicative value". The range of "capital movements" as set out in the nomenclature is wide and is stated to cover all the operations necessary for the purposes of capital movements; conclusion and performance of the transaction and related transfers. The CJEU has also indicated that transactions not listed in the nomenclature may nonetheless constitute a capital movement.

   Although we are not aware of any case in which the CJEU has specifically considered whether any of FX Products constitute a movement of capital for the purposes of Article 63(1), it follows from the wide definition of capital movement contained in the nomenclature and recognised by the CJEU, that the operations which comprise FX Products should be movements of capital for the purposes of Article 63(1). This approach is consistent with the prevailing academic view and the view taken by the ECB in its analysis of the Belgian currency transaction tax; a tax which, like the FTT, applied to FX Products generally (as well as spot FX). It is also consistent with statements made by the Commission in its 2011 impact assessment for the originally proposed pan-EU FTT[1] (see paragraphs 6 et seq. below);

(b) the FTT constitutes a "restriction" on such movements of capital because it will greatly increase the cost of entering into FX Products[2] and is thus liable to deter the entry into such products. In addition, the FTT (as it applies to the FX Products) is indirectly discriminatory, because it makes it more expensive for a company based in a non-Eurozone state to conduct business in a Eurozone state (and vice versa) in comparison to its local competitors; and

(c) the only justification for such a restriction which is likely to be considered potentially relevant by the CJEU, were it to ever consider the point, is a public policy justification, i.e. that the restriction can be justified by reason of its objectives which, in this case, are:

(i) to avoid fragmentation in the internal market for financial services, to ensure financial institutions make a fair contribution to covering the costs of the recent crisis;

(ii) to ensure a level playing field with other sectors from a taxation point of view;

(iii) to create appropriate disincentives for transactions that do not enhance the efficiency of financial markets; and

(iv) to create a new source of revenue for the European Union or the participating member states.

However the contested nature of these claims mean that it is arguable whether the CJEU would accept that they *prima facie* constitute a valid justification; and

1 Commission Impact Assessment (SEC/2011/1102) accompanying the publication of the 2011 proposal for a Council directive on a common system of financial transaction tax and amending Directive 2008/7/EC (SEC/2011/1102), volume 8, pages 13 and 14

2 Global Financial Markets Association FTT Briefing Note, "The Proposed EU FTT - Impact on the Foreign Exchange Markets"

(d) even if the stated objectives of the FTT are accepted to constitute a valid justification, the FTT is in our view disproportionate given that:

(i) the scope of the tax is considerably wider than any of the national measures which it seeks to harmonise;

(ii) the definition of "financial institution" to which it applies goes considerably beyond those entities which are said to be responsible for the crisis and/or benefit from the VAT exemption;

(iii) alternative fiscal or regulatory disincentives could be created that would achieve the stated objective of discouraging transactions that do not enhance the efficiency of the financial markets, but without the disproportionate effects on corporates, pension funds and others seeking to hedge FX risk in relation to their ordinary course trading and investment transactions; and

(iv) it is settled CJEU case law that purely economic objectives (e.g. revenue raising) alone cannot justify the restriction of a fundamental freedom.

We consider the FTT as applied to FX Products is disproportionate, and that the public policy justification is unlikely to be applicable.

4. We therefore conclude that the better view is that the application of the FTT to FX Products would be regarded as an unjustified infringement on the movement of capital and contrary to European Union law.

5. The Commission's view is that it would be unlawful to apply the FTT to spot FX but that operations comprising FX Products may lawfully be taxed[3]:

> "*[C]urrency transactions on spot markets are outside the scope of the FTT, which preserves the free movement of capital. However, derivatives contracts based on currency transactions are covered by the FTT since they are not as such currency transactions.*"

We are not aware of any case law which supports this proposition. The suggestion that spot FX and other FX Products can be distinguished seems at odds with the economic similarity of the products in question. For instance, the difference between spot FX and FX forward transactions is solely one of degree, namely, the amount of time between the moment that the amount of the respective payments is fixed and the moment when those payment are actually made. In the case of spot FX transactions,

[3] Explanatory Memorandum to the 2013 proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax (COM/2013/71), page 9

this period is usually one or two days, while in the case of FX forwards, it is (by market convention) a period of two days or longer. It is difficult to see why this difference should be grounds for treating spot FX transactions as a capital movement, but not FX forwards. Similarly, an FX swap is comprised of a spot FX transaction and an FX forward (or an FX forward and an FX forward). It is not obvious how one would establish a principled distinction between an FX swap and the transactions which constitute it. An FX option is simply the right but not the obligation to carry out a spot FX transaction at a future date.

6. The Commission's statement above is also contradicted by a statement in its 2011 impact assessment for the original pan-EU FTT, which accepts that a hypothetical "Currency Transaction Tax" which applied to FX Products would restrict the movement of capital[4]:

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

7. The assessment then goes on to consider whether this can be justified[5]:

> "*Nothing can justify this restriction [i.e. the restriction on the fundamental freedoms which a Currency Transaction Tax would entail], since the cross-border flows affected are not objectively different from purely national flows (or flows within a single currency zone [i.e. the Eurozone]), nor could any overriding reason relating to the public interest serve as a justification. Even if e.g. raising funds to benefit stability funding were to be considered as an overriding requirement of general interest, that requirement could not explain why transactions involving countries with different currencies would be treated less favourably than those involving only one currency.*

[4] Commission Impact Assessment (SEC/2011/1102) accompanying the publication of the 2011 proposal for a Council directive on a common system of financial transaction tax and amending Directive 2008/7/EC (SEC/2011/1102), volume 8, pages 13 and 14

[5] ibid

[T]he tax is considered to be disproportionate as funds could alternatively be raised by other means of budget attribution without affecting a basic freedom of the Treaty and, in any event, because the scope of the tax would be unrelated to the risks to be covered by the tax revenue raised. Even a very low tax rate would constitute an infringement, and it would not be possible to establish a threshold of insignificance."

8. The assessment concludes[6]:

"*this option [i.e. the Currency Transaction Tax] raises legal concerns which would need to be addressed by adapting core elements of the TFEU.*"

9. It can therefore be seen that the Commission itself has previously recognised that a tax on FX Products would be incompatible with the TFEU. It is unclear why their view on the point has changed.

10. There have been some suggestions in the Press that the FTT might be extended so as to cover spot FX transactions. We consider that any such application of the FTT should also be regarded as an unjustified infringement on the movement of capital and therefore contrary to European Union law (and it seems clear that this is the Commission's view as well).

11. We therefore conclude that the better view is that the application of the FTT to FX Products would be regarded as an unjustified infringement on the movement of capital and therefore contrary to European Union law.

12. We would add two points to this conclusion. First, whilst we were asked to consider the legality of the FTT as applicable to the FX Products only, much of the reasoning in our opinion is equally applicable to other transactions. Secondly, we would note that there may be other grounds for querying whether the FTT is unlawful (e.g. it may contravene the conditions for enhanced cooperation set out in Article 20 of the Treaty on European Union and Articles 326 to 334 TFEU, it may be *ultra vires* Article 113 TFEU (which relates to the harmonisation of indirect taxation), it may be inconsistent with the principle of subsidiarity, and/or it may contravene the freedom of establishment under Article 49 TFEU), however our scope for this opinion related solely to Article 63 TFEU.

Clifford Chance LLP

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[6] ibid