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Real economy

The purpose of this paper, presented by several Member States to the Working Party on Tax Questions (Indirect Taxation), is to allow for an integrated technical exploration of issues that need to be considered when designing a FTT. The paper is based on individual contributions from Member States and, thus, it does not reflect, in any way, the position of any Member State or group of Member States. The document also suggests a number of questions, that the Presidency could put forward in the meeting of the WPTQ.

The intention of this document is to provide a neutral and objective view on the different options on how to avoid potential negative impacts of a FTT on that part of the economy that is concerned with producing, distributing and consuming goods and non-financial services (i.e. "real economy").

One major goal of the Commission's proposal for a Council Directive implementing an enhanced cooperation in the area of financial transaction tax (FTT) of 14th February 2013[1] is to ensure '*that financial institutions make a fair and substantial contribution to covering the costs of the recent* [financial] *crisis and creating a level playing field with other sectors from a taxation point of view*'.

Given its aim of covering transactions relating to all types of financial instruments, the scope of the FTT proposed by the Commission is wide. While the tax is aimed at the financial sector, it has to be assessed whether the FTT might have unintended impacts on the real economy and, if so, how the Commission's proposal deals with this issue.

In practice, real economy enterprises are often interested in hedging some or all of their business risks (covering commercial risks, e.g. currency/exchange rate risk (one currency dropping in relation to another), price risk (increasing or falling prices of goods), interest rate risk, etc.). Consequently they often enter into derivative contracts to reduce their exposure to commercial risks.

1. The Commission's proposal

According to Article 2(1) No. 2 the motive for entering into a certain financial transaction is not relevant. In principle, also the covering of commercial risks through derivative contracts performed by or on behalf of real economy enterprises would be seen as a taxable *financial transaction*.

[1] COM (2013) 71 final.

But only financial institutions established or deemed to be established in a participating Member State party or intervening in a financial transaction are liable to tax. While investment firms, credit institutions, etc., are financial institutions (Article 2(1)(8)(a) to (i)). Even though the intention of the Commission's proposal is to cover entities that might mimic financial institutions as defined in letters a) to i) e.g. new types of special purpose vehicles, a real economy enterprise could be deemed a *financial institution* if it fulfils the "catch-all" clause of Article 2(1)(8)(j):

'Financial institution' means any of the following: […]
j) any other undertaking, institution, body or person carrying out one or more of the following activities, in case the average annual value of its financial transactions constitutes more than fifty per cent of its overall average net annual turnover, as referred to in Article 28 of Council Directive 78/660/EEC14:
(i) activities referred to in points 1, 2, 3 and 6 of Annex I to Directive 2006/48/EC;
ii) trading for own account or for account or in the name of customers with respect to any financial instrument;
(iii) acquisition of holdings in undertakings;
(iv) participation in or issuance of financial instruments;
(v) the provision of services related to activities referred to in point (iv)[…]

The Commission's proposal already includes several provisions to protect the real economy from the unintended effects of a FTT:

- As long as real economy enterprises do not meet the catch-all clause they remain non-financial institutions and would have no FTT liability;
- For the calculation of the threshold of the catch-all clause, the Commission's proposal in Article 2(3)(d) adjusts the relevant value of derivatives contracts ('[…]*the value of each transaction referred to in Article 7 shall be <u>ten per cent</u> of the taxable amount as defined in that Article*[…]'). Thus, non-financial companies hedging risks with a notional amount of up to 5 times their annual turnover would not be covered by this catch-all clause. This significantly reduces the risk for enterprises of the real economy to be seen as financial institutions under the FTT Directive;
- Lower tax rates for derivatives reduce the amount (and impact) of the FTT.

However, it could be considered that:

- Financial institutions might try shifting the tax burden to the real economy side of the transaction.
- Even low tax rates could turn out to be significant and heavy, in relation to the overall costs of covering commercial risks, especially when levied on products with a short maturity (and rolled over as part of the hedging strategy of the company).

In its impact assessment of 2013, the Commission explicitly touched upon such micro-economic effects and came to the conclusion that on balance the effects should be minor and would, thus, not require mitigating measures beyond those already included in its proposal. [2]

Questions:
How do Member States assess the impact of the Commission's proposal on the real economy?
Do Member States see the necessity to have a "catch-all" clause in order to prevent tax planning in this context?

2. European Parliament

a. Proposal of the European Parliament

In its legislative resolution of 3 July 2013[3] on the proposal for a Council directive implementing enhanced cooperation in the area of financial transaction tax the European Parliament proposed two amendments concerning Article 2(3) of the Commission's proposal:

Amendment 28	
Proposal for a directive **Article 2 – paragraph 3 – point d**	
Text proposed by the Commission	*Amendment*
(d) where the average annual value of financial transactions in two consecutive calendar years does not exceed **fifty** per cent of the overall average net annual turnover, as defined in Article 28 of Directive 78/660/EEC, the undertaking, institution, body or person concerned shall be entitled, upon request, to be considered as not being or no longer being a financial institution.	(d) where the average annual value of financial transactions in two consecutive calendar years does not exceed **20 %** of the overall average net annual turnover, as defined in Article 28 of Directive 78/660/EEC, the undertaking, institution, body or person concerned shall be entitled, upon request, to be considered as not being or no longer being a financial institution.

[2] See SWD (2013) 28 final, page 48/49.

[3] P7_TA(2013)0312.

Amendment 29	
Proposal for a directive **Article 2 – paragraph 3 – point d a (new)**	
Text proposed by the Commission	*Amendment*
	(da) the calculation of the average annual value of financial transactions referred to in that point shall not take account of financial transactions concerning non-OTC derivative contracts which meet one of the criteria referred to in Article 10 of Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP.

b. Identification of transactions which are directly linked to real economy's business

As shown above, under the initially proposed regime of the FTT the covering of commercial risks by means of derivative contracts are taxable transactions, which can be taxed at least once, tax being due by the financial institutions that are parties to such transactions. On the other hand, even if a "real economy" company is not considered to be a financial institution, a normal financial institution might intervene on its behalf and pass the burden of its FTT to the company.

Following the approach suggested by the European Parliament, one could try to assess, whether it is possible to identify transactions which are directly linked to the risk hedging activities of real economy enterprises. This would give the opportunity to treat these specific transactions differently from other transactions.

When negotiating EMIR Regulation[4] European Parliament and Council met a similar task. Besides comprehensive reporting obligation for all financial counterparties (FCs) and non-financial counterparties (NFCs) this regulation imposes a clearing obligation for all derivative contracts. The European Parliament and Council came to the conclusion that the (costly) clearing obligation seemed to be too far-reaching for NFCs.[5]

In order to be granted a privilege, NFCs need to report whether a derivative contract is directly linked to commercial risks or treasury financing as referred to in Article 10(3) of Regulation (EU) No 648/2012 (EMIR) by indicating a 'YES' in FIELD 15 of their report[6]. These derivative contracts do not lead to a clearing obligation of the NFCs. FCs are obliged to leave FIELD 15 blank in their report[7]. FIELD 15 is subject to audited accounting standards (IAS, IFRS).

Whether an OTC derivative contract is objectively reducing (commercial) risks, is defined in Article 10 COM DR 149/2013.[8] [9]

IFRS 9 "Financial instruments" confirms that hedging instruments (derivatives) serve to hedge (offset, cover) the exposure to changes in fair value of an asset or liability, variability in cash flows (e.g. future interest payments), that is attributable to a particular risk and could affect profit or loss, or of a net investment in a foreign operation. The hedging operation needs to be documented ex-ante in order to qualify for hedge accounting.

If the idea would be to apply the principles reflected in EMIR to the future FTT regime, the following avenues could be explored:

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[4] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

[5] EMIR, recital 29: '*[...] in determining whether a non-financial counterparty should be subject to the clearing obligation, consideration should be given to the purpose for which that non-financial counterparty uses OTC derivative contracts [...].*'

[6] Excerpt of COM DR 148/2013.

[7] COM DR 148/2013.

8 'An OTC derivative contract shall be objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the non-financial counterparty or of that group, when, by itself or in combination with other derivative contracts, directly or through closely correlated instruments, it meets one of the following criteria:[...]

(a) it covers the risks arising from the potential change in the value of assets, services, inputs, products, commodities or liabilities that the non-financial counterparty or its group owns, produces, manufactures, processes, provides, purchases, merchandises, leases, sells or incurs or reasonably anticipates owning, producing, manufacturing, processing, providing, purchasing, merchandising, leasing, selling or incurring in the normal course of its business;

(b) it covers the risks arising from the potential indirect impact on the value of assets, services, inputs, products, commodities or liabilities referred to in point (a), resulting from fluctuation of interest rates, inflation rates, foreign exchange rates or credit risk;

(c) it qualifies as a hedging contract pursuant to International Financial Reporting Standards (IFRS) adopted in accordance with Article 3 of Regulation (EC) No 1606/2002 of the European Parliament and of the Council with its further amendments.

[9] Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP

- Exempting the whole transaction (relief for both the real economy enterprise and the financial institution as the counterparty)[10] directly linked to commercial risks,
- Exempting solely the real economy side of such a transaction (relief on one side),[11]
- Reducing the tax rates for financial transactions that aim at covering commercial risks of real economy enterprises,
- Adjusting the "catch-all" as proposed by the European Parliament.

It has to be noted that ESMA recently voiced concerns as regards the workability and enforceability of EMIR rules concerning the reporting on covering commercial risks.[12]

A tax rule based on these reports would require liable data and a proper enforcement of compliance to regulation.

Questions:

While the Council acts as a sole legislator in tax matters, how do Member States assess the amendments proposed by the European Parliament?

Do Member States believe that the EMIR mechanism can be used in order to identify financial transactions which are directly linked to covering commercial risks by real economy enterprises?

[10] Transactions directly linked to covering commercial risks of real economy companies would not be taxed
To profit as a counterparty to an NFC party from the real economy relief one needs to prove to be the relevant counterparty of a privileged transaction. This incentives a functioning matching process under EMIR reporting
[11] NFC parties to a transaction that are under the present COM's proposal taxable according to Article 2(1) No 8 letter j are not taxed with respect to transactions directly linked to covering their own commercial risks.
[12] ESMA Review Report No. 1, 13 August 2015, ESMA/2015/1251, see chapter 4.2.