

# Impact of EU Financial Transaction Tax on the asset management industry

Global FS Tax Newsflash

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***In our earlier Newsflashes, we have considered the content, form and timing of the draft proposals to implement an EU Financial Transaction Tax (“FTT”) and the implications for the Financial Services sector. In this Newsflash, we look specifically at the impact of the EU FTT on the asset management industry.***

***On 14 February 2013, the European Commission issued a new draft Council Directive to implement an EU FTT in 11 countries. In our Newsflash of 14 February, we highlighted that the Directive has a very broad scope and will impact both EU and non-EU Financial Institutions. The costs of the tax, coupled with the major operational changes that will be required to comply with the regime, will result in the EU FTT being a significant cost for Financial Institutions and their clients.***

***Investment firms, UCITS and their management companies, alternative investment funds and their managers, pension funds and their investment managers can be heavily impacted by the Directive.***

***There remains much uncertainty about the timing and form of the ultimate EU FTT. However, the asset management industry will be affected by the proposed tax. In this Newsflash we highlight how funds could fall within the scope of the tax, explain the impact that we expect the FTT to have on asset managers and advise on what actions institutions in this sector should be taking now.***

## ***Funds are in scope***

The latest EU FTT Directive (“the Directive”) classifies fund vehicles and management companies as Financial Institutions for the purposes of the FTT. Financial Institutions resident in EU FTT countries<sup>1</sup>, Financial Institutions trading with other Financial Institutions located in EU FTT countries or Financial Institutions dealing in securities issued within an EU FTT country are all chargeable to EU FTT on in-scope transactions.

Under the Directive, also trading in fund units or shares in funds (including UCITS and alternative funds) can be subject to FTT. In addition, the fund’s trading of its own underlying investment portfolio can also be subject to the tax. This means that

the FTT needs to be considered both at the investor level and the fund portfolio level.

However, as the Council Directive 2008/7/EC prohibits the imposition of taxes on the raising of capital, the initial issuance of interests in investment funds will not be subject to the FTT under the revised proposal. Placing funds within the scope of the EU FTT would seem to breach the principle that investing via investment funds should be tax neutral as compared with direct investment in the underlying fund assets. As a result of the breach of this principle, investing via funds will become more expensive than investing directly.

Pension funds are in the scope of the FTT under the current version of the Directive. The European Commission has considered

1. The ‘FTT zone’ is now limited to the participating Member States (currently Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain).

exempting pension funds from the FTT, but it was concluded that such an exemption was not feasible. The Netherlands has expressed an interest in joining the EU FTT but, given the importance of the pension fund sector for the Netherlands, the current position of the Netherlands is that it will not join the FTT unless specific exemptions are introduced into the regime for these funds.

We have set out below the key ways in which the EU FTT will impact the funds sector.

### ***Areas of impact***

There are three main areas in which fund structures will be impacted:

- FTT charges arising as a result of transactions undertaken at the investment portfolio level;
- FTT charges arising in connection with the sale, purchase or redemption of fund interests as a result of the fund being located within the FTT zone; and
- FTT charges arising in connection with the sale, purchase or redemption of the interests in funds located outside of the FTT zone where investors, distributors or brokers located within the FTT zone are involved in the distribution chain.

### ***Investment portfolio***

Broadly, the FTT applies to financial transactions where at least one Financial Institution established in the FTT zone is party to the transaction (this is often referred to as the “residency principle”).

Therefore, where a fund is investing as principal and is located in an FTT country, then transactions in its investment portfolio will be subject to the FTT, regardless of the markets in which the fund invests.

Moreover, where a Financial Institution that is not established in a FTT country enters into a transaction with a party established in a FTT country, the first Financial Institution will be deemed to be established in that FTT country. As the Financial Institution is deemed to be

established in the FTT country the transaction will become taxable under the FTT for both parties.

To illustrate the residency principle, the following transactions would result in an EU FTT charge:

- A Luxembourg UCITS fund or Hong Kong fund undertaking transactions with a French broker as counterparty.
- Transactions undertaken by a UK or US branch of a French investment firm.
- Transactions undertaken by a French branch of a UK or US based fund manager.

The residence principle is supplemented in the Directive by the “issuance principle”. This brings transactions in financial instruments issued in a FTT country within the scope of the tax, even where both parties are outside the FTT zone. For example, if a US bank sold shares in a German company to an Irish fund, both the US bank and the Irish fund will become subject to the EU FTT in Germany, notwithstanding that neither the US nor Ireland is participating in the EU FTT.

The issuance principle is subject to an “economic substance” exemption. If a party in a non-FTT country can prove that there is no link between the economic substance of the transaction and the territory of a FTT country, the underlying financial transaction will not be subject to FTT. There is currently no further guidance as to how this exemption will be applied in practice.

### ***Distribution of fund interests in FTT-zone funds***

Funds located in an FTT country issuing units or shares will not be subject to FTT on the issuance of those shares or units. However, any secondary trading or

redemptions of those shares or units will be subject to FTT.

This creates a benefit for funds located in e.g. Luxembourg, UK, Ireland, The Netherlands, and any other country outside the EU (US, Switzerland, Hong Kong etc).

### ***Distribution of fund interests in non FTT-zone funds***

Even where the fund is not located in the FTT zone, FTT charges could still arise in respect of sales, purchases and redemptions of fund interests where those transactions involve a Financial Institution or investor in an FTT country.

### ***Cascading***

Under the Directive, more than one FTT charge will arise where there are multiple Financial Institutions involved in the transaction chain.

For example, a transaction to purchase securities that involves a number of in-scope Financial Institutions (e.g. a series of brokers) could result in multiple charges to EU FTT applying. It is likely that such transaction costs will ultimately be borne by the end investor.

Similar issues can arise where there are multiple Financial Institutions involved in the distribution chain. Consequently fund-to-fund structures, master feeder structures and pooling structures may be impacted.

Related risk management strategies such as hedging transactions in respect of the fund's portfolio may also be subject to FTT.

### ***Next steps***

There are a number of steps that institutions need to take to prepare for the EU FTT. We have set these out below, identifying those which must be taken now and the steps to be taken before the end of this year.

### ***Now***

Undertake an impact assessment to identify how the EU FTT will affect your business and your business strategy.

To the extent that it is possible, constructively engage with Governments (within the FTT zone) to highlight the practical problems which arise from the current proposal.

Consider how (under the current Directive) it will be necessary to adapt existing systems and processes, investment strategies and distribution arrangements.

### ***Before the end of this year***

Update business plans, projected financials and business strategy to take account of the impact of the EU FTT.

Update and adapt systems and processes to capture and pay any liability to EU FTT.

Engage with third party service providers to determine who will be responsible for accounting for the EU FTT and reporting to the relevant authorities.

## *PwC contacts*

If you would like further advice or information in relation to the issues outlined above, please call your local PwC contact or any of the individuals listed below:

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