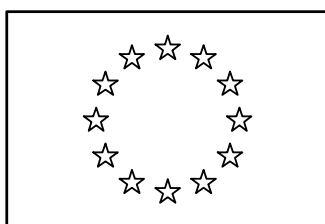


FIRST REPORT

2006



FACT-FINDING STUDY

**ON FISCAL COMPLIANCE PROCEDURES
RELATED TO CLEARING AND
SETTLEMENT WITHIN THE EU**

**THE FISCAL COMPLIANCE
EXPERTS' GROUP - FISCO**

TABLE OF CONTENTS

1. COMMUNITY LAW BACKGROUND	2
1.1. INTRODUCTION	2
1.2. DISPARITIES.....	2
1.3. DISCRIMINATIONS AND RESTRICTIONS	2
1.4. EXISTING EU LEGISLATION	3
1.5. THE FOUR FUNDAMENTAL FREEDOMS	4
1.6. FISCAL REPRESENTATIVES	8
1.7. TAX OBSTACLES.....	8
1.8. EFFECT OF BARRIERS ON OTHER EU POLICIES	9
1.9. CONCLUSIONS.....	10
2. WITHHOLDING TAX PROCEDURES (GIOVANNINI BARRIER 11)	11
2.1. INTRODUCTION	11
2.2. DIFFERENCES IN TAX COLLECTION AND RELIEF PROCEDURES	11
2.3. AREAS NOT PROPERLY ADAPTED	14
2.4. ANALYSIS OF WITHHOLDING TAX ISSUES IN THE LIGHT OF EU-LAW	27
2.5. CONCLUSIONS.....	31
3. TRANSACTION TAX PROCEDURES (GIOVANNINI BARRIER 12)	33
3.1. INTRODUCTION	33
3.2. MARKETS	34
3.3. CONCLUSIONS.....	46
4. DO SECURITIES TRANSACTION TAXES AFFECT MARKET LIQUIDITY?	48
4.1. INTRODUCTION	48
4.1. SCOPE OF ENQUIRY AND DEFINITIONS.....	49
4.2. EXISTING LITERATURE ON THE EFFECTS OF TRANSACTION TAXES	51
4.3. COUNTRIES	54
4.4. CONCLUSIONS.....	67
5. CONCLUSIONS	69
ANNEX I. BIBLIOGRAPHY	72
ANNEX II. MANDATE FOR THE EU CLEARING AND SETTLEMENT FISCAL COMPLIANCE EXPERTS' WORKING GROUP	73
ANNEX III. GIOVANNINI REPORT; FISCAL COMPLIANCE BARRIERS 11&12	76
ANNEX IV. MEMBERS OF THE CLEARING AND SETTLEMENT FISCAL COMPLIANCE EXPERTS' GROUP	77

PREFACE

The EU Clearing and Settlement Fiscal compliance Experts' Group – FISCO - was created in March 2005 following the Communication “Clearing and Settlement in the European Union – The way forward” (ref: COM(2004) 312 final). The aim of this Experts' Group is to give advice on the removal of Fiscal Compliance barriers to the clearing and settlement of EU cross-border securities transactions. The key issues considered by the FISCO Group are Giovannini Barriers 11 and 12 on withholding and transaction tax procedures respectively. (Two other Expert Groups have also been set up for the Giovannini barriers on clearing and settlement: The CESAME Group on market-led initiatives to bring down industry related clearing and settlement barriers to integration and the Legal Certainty Group to tackle legal clearing and settlement barriers).

The present document is a fact-finding study on fiscal compliance procedures related to EU clearing and settlement and has been produced by the FISCO Group in line with its mandate (see Annex II, Mandate). The aim of this fact-finding study is to ascertain the many different fiscal compliance procedures within the Member States, which hinder the functioning of the capital markets and raise the cost of cross-border settlement with respect to withholding and transaction tax procedures.

A second report by FISCO, proposing solutions is planned for the end of 2006.

FISCO is composed of 15 high-calibre experts, mainly from private bodies and the academic community. To facilitate its work, the Commission is providing a Secretariat made of a Chairperson, a Secretary and four expert members.

All reports and other FISCO documents are available on the FISCO website:

http://europa.eu.int/comm/internal_market/financial-markets/clearing/compliance_en.htm

The Commission will use the FISCO findings as a basis for discussion with the Member States in line with its established policy of prior consultation on tax issues led by Directorate-General Taxation and Customs Union.

1. COMMUNITY LAW BACKGROUND

1.1. INTRODUCTION

The first Giovannini Report of November 2001 identified 15 barriers associated with the clearing and settlement of cross-border securities transactions within the EU. Two of these barriers relate to taxation. Barrier 11 stipulates that foreign intermediaries cannot offer withholding tax relief at source or only under the condition that they have a fiscal agent. Barrier 12 consists of national provisions requiring that taxes on securities transactions must be collected via local systems.

This chapter presents some elements of Community law to facilitate the understanding of their influence on these two barriers. It also discusses the influence of Community law on some tax-related barriers that have a more general impact on the efficiency of cross-border securities transactions.

1.2. DISPARITIES

When examining the potential impact of Community law on tax rules it is necessary to distinguish between tax barriers which result from disparities between national tax systems and tax barriers which are not in conformity with the EC Treaty. An example of a typical tax disparity is that one Member State may have a low tax on labour income, and another Member State may have a high tax on such labour income. If workers move from the low-tax country to the high-tax country, they may claim that the higher tax on labour income hinders their mobility. While they may indeed be hindered, Member States are nevertheless free under current Community law to set their income tax bases and rates. Such a disparity is not a restriction of the Treaty freedoms. Different tax rates are justified by different conditions in each Member State, such as different social responsibilities.

The Giovannini Report identified national differences in granting withholding tax relief as tax disparities that should be resolved as a matter of priority. Although practically all the tax treaties between the Member States are based on the OECD Model Tax Convention, there are no common procedures for claiming tax treaty benefits.

1.3. DISCRIMINATIONS AND RESTRICTIONS

There may also be tax barriers which are not in conformity with the EC Treaty. If such obstacles are not eliminated by a Member State on its own initiative they may ultimately be resolved via the infringement procedure under Article 226 of the EC Treaty or via the procedure for preliminary rulings under Article 234 of the EC Treaty.

An example of such a tax obstacle which was eliminated by the Court of Justice is the situation where the first €500 of domestic dividends was exempt for an individual shareholder, but not for inbound dividends, i.e. paid by a company of another Member State (Verkooijen, Case C-35/98).

Another recent example involving the European Court of Justice is the 'Bouanich' Case (C-265/04). In this case, the ECJ issued a decision that condemns the potentially more favourable tax treatment in Sweden of Swedish resident shareholders of payments related to the repurchase of shares in Swedish companies than the one of non-resident shareholders receiving such payments.

An example where legislation has been amended by a Member State on its own initiative involves a Case (No. 9712841/1) before the Tribunal Administratif de Paris. According to Article 125 A III of the French tax code, interest on French debt securities is subject to a levy of 16% if the income is paid to French investors and the payment is made outside France. French beneficial owners that hold their French debt securities in France are not subject to this tax levy. In 2004, the Tribunal ruled that this violated European rules on the free movement of capital (Article 56 EU Treaty) because it discouraged French beneficial owners from holding French debt securities with a custodian located in another EU Member State. The French legislation has been amended with effect from 1 January 2006.

1.4. EXISTING EU LEGISLATION

There are three EU directives that relate to withholding taxes: the Savings Directive (2003/48/EC), the Interest and Royalties Directive (2003/49/EC) and the Parent-Subsidiary Directive (90/435/EEC and 2003/123/EC).

The aim of the Savings Directive is to ensure that savings income in the form of interest payments made in one Member State to beneficial owners who are individuals resident for tax purposes in another Member State is subject to effective taxation under the laws of the latter Member State. Three Member States are transitionally allowed to pursue this aim by levying a withholding tax on interest payments and sharing the tax revenue with the Member State of residence of the beneficial owner, but after the end of a transitional period they should, like the other Member States, provide for an automatic exchange of information with no further obligation to levy withholding tax.

The Interest and Royalties Directive is designed to eliminate withholding tax obstacles to cross-border interest and royalty payments within a group of associated companies by abolishing withholding taxes on interest and royalty payments arising in a Member State. These interest and royalty payments are exempt from any taxes in that Member State provided that the beneficial owner of the payment is an associated company or a permanent establishment of an associated company in another Member State. The Interest and Royalties Directive covers only companies that are subject to corporate tax in the EU, tax-resident in an EU Member State and of a type listed in the annex to the Directive.

The Parent-Subsidiary Directive has the dual aim of abolishing withholding taxes on dividend payments between associated companies of different Member States, including the permanent establishments of those companies, and of eliminating economic double taxation on distributed profits. The latter aim is achieved by obliging the Member State of the parent company to either exempt the distributed profits from tax or grant a credit for tax charged on those profits in the Member State of the subsidiary or in the Member State of any sub-subsidiary. In order to be within the scope of the Directive, companies must take one of the forms listed in the Annex to the Directive, be tax resident in a Member State, and be subject to corporate tax in the EU.

1.5. THE FOUR FUNDAMENTAL FREEDOMS

The Internal Market is founded on four fundamental freedoms:

- The free movement of goods;
- The free movement of persons – split into free movement of workers and freedom of establishment;
- The freedom to provide services; and
- The free movement of capital.

In 1995, the Court made its now classic statement in the Schumacker case: “Although, as Community law stands at present, direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law”¹.

As the fundamental freedoms apply to all areas of national law, and the Court wishes to preserve the cohesion of its interpretation of the Treaty, any judgment relating to, for example, the fundamental freedoms and the use of academic titles (Kraus)² or the transfer of football-players (Bosman)³ can have a direct impact in the area of taxation. The definition of “restriction” given in these cases will therefore have an influence in the area of taxation as well.

The Court chose to align the interpretations of the different freedoms. Accordingly, as will be shown below, any case-law on discrimination or restrictions in relation to any of the four freedoms may influence the interpretation of one of the other freedoms. The Court has extended the application of the Treaty freedoms from situations of discrimination to situations where these freedoms are restricted.

As far as the free movement of goods is concerned, the Court had already found in 1974 that “all trading rules enacted by Member States which are *capable of hindering, directly or indirectly, actually or potentially, intra-Community trade* are to be considered as measures having an effect equivalent to quantitative restrictions” and are as such prohibited by Article 28 EC (Dassonville).⁴ The Court was hesitant, however, to apply the Dassonville criteria to national rules which apply equally, without distinction, to imported as well as to domestic goods. This left scope for drafting national legislation in such a manner as to escape the prohibition.⁵ As a result, the Court started to apply the Dassonville criteria to national

¹ Judgment of 14 February 1995, Case C-279/93, Finanzamt Köln-Altstadt v Roland Schumacker, Paragraph 21

² Judgment of 31 March 1993, Case C-19/92 Kraus [1993] ECR I-1663

³ Judgment of 5 December 1995, Case C415/93, Bosman, [1995] ECR I-4921

⁴ Judgment of 11 July 1974, Case 8/74, Procureur du Roi v. Dassonville et al. [1974] ECR 837

⁵ See Case 50/83, Commission v. Italy, a national law prohibiting granting a registration plate to imported coaches was replaced by a national law prohibiting the granting of a first registration plate to coaches older than 7 years: in practice of course only imported coaches would be older than 7 years when registered for the first time in Italy

legislation that applied to both imported and domestic products. Where the subject matter of the national legislation has already been the object of Community legislation, the Court applies the Dassonville criteria quite strictly. In the absence of any Community legislation, the Court is more lenient. In Dassonville itself, for example, the Court allowed a national measure, which was restrictive, provided the restriction was justifiable by reference to the rule of reason.

This was clarified by the Court in the Cassis de Dijon-case⁶ which mentioned the preconditions as follows:

- if community legislation is lacking; and
- the measure applies without distinction to national and imported products; and
- the interest which the measures tries to protect is of sufficient weight/overriding importance; and
- when the national measure is proportionate; then the national measure was not in violation of EC law.⁷

The Treaty provisions on the free movement of persons were drafted to prohibit discrimination. In its early case-law the Court limited itself to finding that national legislation contravened the free movement of workers or the freedom of establishment because it discriminated. Later on, the Court considered that these articles also prohibited indirect discrimination as to nationality. In 1974, the Court held that the Treaty prohibited not only overt discrimination by reason of nationality but also all covert forms of discrimination which, by the application of other criteria for differentiation, lead to the same result.⁸ This was first applied to tax cases in 1990: Luxembourg tax legislation did not allow for the repayment of any excess tax to persons who took up residence in Luxembourg or who left Luxembourg in the course of the year. As the Court noted, there was a risk that this would apply in particular to taxpayers who are nationals of other Member States.⁹ In 1993, the Court departed from its earlier approach of interpreting the freedom of workers only in terms of the prohibition of discrimination. In Kraus, a case relating to the conditions under which an academic title obtained in another Member State may be used, the Court held that article 43 EC precludes a measure, which, even though applying without discrimination on grounds of nationality, is liable to hamper or to render less attractive the exercise by Community nationals, including those of the Member State who enacted the measure, of fundamental freedoms guaranteed by the Treaty.¹⁰

Unlike the free movement of workers, the freedom of establishment, the free movement of capital and the freedom to provide services were drafted to prohibit restrictions. In 1998 the

⁶ Judgment of 20 February 1979, 120/78 Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein (“Cassis de Dijon”) [1979] ECR 649

⁷ Later though, the court partially moved back to a discrimination approach: in respect of national legislation which did not concern the goods themselves but the methods or circumstances of sale and distribution, the Court limited its check to a test of discrimination, judgment of 24 November 1993, case C-267 and 268/ 91 Keck and Mithouard [1993] ECR I-6097

⁸ Judgment of 12 February 1974, Case 152/73 Sotgiu v Deutsche Bundespost [1974] ECR 153 paragraph 11.

⁹ Judgment of 8 May 1990, Case C-175/88, Klaus Biehl v Administration des Contributions du Grand-Duché de Luxembourg.

¹⁰ Judgment of 31 March 1993, Case C-19/92 Kraus [1993] ECR I-1663, paragraph 32

Court held in *Safir* that Swedish tax legislation contained a number of elements *liable to dissuade* individuals from taking out capital life assurance with companies not established in Sweden and *liable to dissuade* insurance companies from offering their services on the Swedish market.¹¹

However, the prohibition on the restriction of the free movement of capital in article 56 is qualified by article 58, which states that in respect of taxes Member States are allowed to distinguish between taxpayers who are not in the same situation as far as their place of residence is concerned, provided that this does not amount to arbitrary discrimination or covert restriction. Taken together, articles 56 and 58 EC amount to a prohibition on both restrictions and discrimination, as is the case with the other freedoms.

1.5.1. Application by the Court

The conclusion is that the Court applies the various Treaty freedoms in the same manner. Not only discrimination, but also anything likely to hamper or make less attractive the exercise of one of the freedoms is in principle prohibited. In its interpretation, the Court evidently does not intend to create a different concept of discrimination or restriction for the area of taxation; instead it prefers a uniform set of case-law irrespective of the freedom concerned or the area of national law affected.

1.5.2. Justifications

A discrimination or restriction is only an infringement if there is no justification for it.

In the case of direct discrimination, Member States can rely only on justifications enshrined in the Treaty itself.

In the case of indirect discrimination, Member States can in theory also rely on justifications not explicitly mentioned in the Treaty.

In the case of restrictions, the case-law is much clearer as to the possibility of a justification. In 1995 in *Gebhard*¹², the Court confirmed that the theory of the rule of reason developed in *Dassonville* – in slightly modified wording – can be applied to *all* four freedoms. It stated that national measures liable to hinder or make less attractive the exercise of the fundamental freedoms guaranteed by the Treaty must fulfil four conditions:

- a) they must be applied in a non-discriminatory manner;
- b) they must be justified by imperative requirements in the general interest;
- c) they must be suitable for attaining the objective which they pursue; and
- d) they must not go beyond what is necessary in order to attain it.

Two other grounds have persistently been rejected by the Court. Unfavourable tax treatment that goes against a fundamental freedom can not be justified by the existence of other tax

¹¹ Judgment of 28 April 1998, Case C-118/96, *Jessica Safir*, [1998] ECR I-1897 paragraph 30

¹² Judgment of 20 November 1995, case C- 55/94, *Gebhard*, [1995] ECR I-4165

advantages¹³. Equally, the Court has not accepted budgetary reasons as a justification. As the Court put it in ICI: “it must be pointed out that the diminution of tax revenue occurring in this way is not one of the grounds listed in article 56 of the Treaty and cannot be regarded as a matter of overriding general interest which may be relied upon in order to justify unequal treatment that is, in principle, incompatible with article 52 of the Treaty”¹⁴.

In 1979, in *Cassis de Dijon*, the Court accepted in theory that fiscal supervision can be a justification.¹⁵ In 1997, the Court reiterated this position in *Futura*¹⁶. However, it immediately qualified this by pointing to the existence of the Mutual Assistance Directive. In subsequent cases, the need for fiscal supervision has never been accepted as a justification.

The need to ensure the cohesion of a national tax system was recognised in *Bachmann* and a corresponding infringement procedure against Belgium¹⁷ in 1992. Because of the link between the deductibility of contributions to pension schemes on the one hand and the taxation of the pensions on the other hand, Belgium was allowed to reject the deductibility of payments to foreign insurance companies to ensure the cohesion of the tax system.

However, in subsequent cases in 1995 and 2000¹⁸ the Court narrowed down the possibility of relying on this justification to situations where there was a direct link between deductibility on the one hand and taxation on the other, involving the same tax and the same taxpayer. No direct link existed if Member States submitted a link between corporate income tax on the one hand and personal income tax or wealth tax on the other, or the taxation of a company on the one hand and a tax facility for the shareholder on the other. The Court also made it clear that Member States could not rely on fiscal cohesion to refuse a tax facility if the right to tax the subsequent benefit had been conferred on another Member State in a bilateral tax treaty¹⁹. As the Court puts it, in such situations fiscal cohesion is shifted to another level, that of the reciprocity of the rules in the Contracting States to such treaties.

In the case of “abuse of law” an artificial cross-border construction is created to give the parties access to entitlements on the basis of Community law: the classic example is the (non-tax) case of TV10. A Dutch broadcaster wanted to avoid the Dutch rules on the (minimum) quantity of cultural content in television programmes. The programmes were made entirely in

¹³ Judgment of 6 June 2000 case C-35/98, *Verkooijen*, [2000] ECR I-4071, paragraph 61 which refers in relation to Article 52 of the Treaty, to the judgment of 28 January 1986, Case 270/83 *Commission v France* [1986] ECR 273, paragraph 21; the judgment of 27 June 1996, Case C-107/94 *Asscher* [1996] ECR I-3089, paragraph 53; and the judgment of 21 September 1999, Case C-307/97 *Saint-Gobain ZN* [1999] ECR I-6161, paragraph 54. It also refers in relation to Article 59 of the EC Treaty (now, after amendment, Article 49 EC), to the judgment of 26 October 1999, Case C-294/97 *Eurowings Luftverkehrs AG* [1999] ECR I-7447, paragraph 44.

¹⁴ Judgment of 16 July 1998, case C-264/96, *Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty’s Inspector of Taxes)*, [1998] ECR I-4695, paragraph 28, and reiterated recently in Case C-319/02 *Manninen* [2004] ECR I-7477 paragraph 49.

¹⁵ Judgment of the Court of 20 February 1979, *Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein*, [1979] ECR p. 649, paragraph 8

¹⁶ Judgment of 15 May 1997, Case C-250/95 *Futura Participations SA and Singer v Administration des contributions*, [1997] ECR I-2471

¹⁷ Judgment of 28 January 1992 Case C-204 *Bachmann v Belgian State* [1992] ECR I-249 and judgment of 28 January 1992 Case C-300/90 *Commission v Belgium* [1992] ECR I-305

¹⁸ Judgment of 14 November 1995 case C-484/93 *Peter Svensson and Lena Gustavsson v. Ministre du Logement et de l’Urbanisme*, [1995] ECR I-3955, judgment of 13 April 2000 case C-251/98, *C.Baars v Inspecteur der Belastingen/Ondernemingen Gorinchem*, [2000] ECR I-2787, judgment of 6 June 2000 case C-35/98 *Staatssecretaris van Financiën v. B.G.M. Verkooijen*, [2000] ECR I-4071

¹⁹ Judgment of 11 August 1995, Case C-80/94, *Wielockx*, [1995] ECR I-2493, paragraph 25 and judgment of the Court of 3 October 2002, case C-136/00 *Rolf Pieter Danner*, [2002] ECR I – 8147, paragraph 41

the Netherlands, but were being broadcast from Luxembourg. The Court held that this broadcaster could be treated as a domestic broadcaster, “since the aim of that measure is to prevent organisations which establish themselves in another Member State from being able, *by exercising the freedoms guaranteed by the Treaty, wrongfully to avoid obligations under national law*, in this case those designed to ensure the pluralist and non-commercial content of programmes”.²⁰

In general, the Court only seems to accept a justification based on the risk of tax evasion if the legislation has the specific purpose of preventing wholly artificial arrangements, designed to circumvent tax legislation, from attracting tax benefits.

1.6. FISCAL REPRESENTATIVES

The first Giovannini Report of 2001 stated that it should be possible for all financial intermediaries established within the European Union to act as a withholding agent in all of the Member States. It concluded that in order for this to be possible “it would be necessary to ensure – probably by means of a piece of legislation – that each Member State can recover fully any tax receipts due from another Member State”.

At that time, the Community legislation on mutual recovery assistance (Directive 76/308/EEC) indeed did not apply to taxes on income and capital. The scope of this directive was however amended by Directive 2001/44/EC, which extended the mutual recovery assistance between the EU Member States to their taxes on income and capital, as enumerated in Directive 77/799/EEC. In this regard, it must be observed that the latter directive expressly confirms that “there shall be regarded as taxes on income and on capital, *irrespective of the manner in which they are levied*, all taxes imposed on total income, on total capital, or on elements of income or of capital” (Art. 1(2)). Accordingly, if taxes on income or capital are levied by way of a withholding tax, this levy falls under the scope of the mutual recovery assistance directive. The existence of this Directive (2001/44/EC) can be taken into account when examining the compatibility of requirements for fiscal representatives with the EC Treaty.

1.7. TAX OBSTACLES

In the area of withholding tax procedures the obstacles identified by the Giovannini Report seem to be disparities. By nature they can be dealt with only by co-ordination.

Thorough analysis is needed of the various types of national systems that allow for relief at source. It may be that where such relief is only available through certain domestic operators, this restriction on the freedom to provide services may be contrary to Article 49 of the EC Treaty.

Similarly, national establishment requirements which safeguard the levying of transaction taxes may likewise be contrary to Article 49 of the EC Treaty. It should be noted that transaction taxes are not covered by the Community legislation on VAT or Excise duties.

²⁰ Judgment of 5 October 1994, Case C -23/94 TV10 SA v Commissariaat voor de Media, [1994] ECR I-4795 (Swedish special edition p. I-159; Finnish special edition p. I-161).

Some transaction taxes may fall within the scope of the Capital Duty Directive (69/336/EEC). In any case, however, the general principles of Community law apply to them.

There are a number of other tax restrictions, in addition to the Giovannini barriers to clearing and settlement, which are outside the direct scope of the Giovannini Report but which may have a direct impact on the cross-border holding and transfer of securities. In the first place, the European Commission has already concluded that restrictions on inbound and outbound dividends are not allowed, in its Communication "Dividend taxation of individuals in the Internal Market" of 19 December 2003 (COM/2003/810). The main conclusion of this Communication is that dividends received from another Member State by individual shareholders cannot be subjected to higher taxation than domestic dividends. Similarly, dividends paid to individuals in another Member State cannot be subjected to higher taxation than domestic dividends. The same conclusions apply to dividends received by companies. For instance, withholding taxes on outbound dividends may not be higher than the tax actually levied on dividends in a domestic situation. Several Court cases, including one case before the EFTA Court, have already been decided in this area, and others are pending.²¹

1.8. EFFECT OF BARRIERS ON OTHER EU POLICIES

Irrespective of the conformity of fiscal compliance barriers with EU law, it is also important to consider their direct or indirect effects on the efficiency of other EU policies and legislative measures.

The key proof is the MiFID (the Directive on Markets in Financial Instruments, 2004/39/EC)²². To promote the creation of a single financial market in the EU it tries, among other things, to facilitate the finalisation of securities in cross-border transactions. It considers that for this to be achieved "*it is appropriate to provide for access to clearing and settlement systems throughout the Community by investment firms, irrespective of whether transactions have been concluded through regulated markets in the Member State concerned*"²³.

This policy aim is put into effect through its Article 34 which essentially introduces the right of investment firms to obtain non-discriminatory direct remote access to foreign clearing and settlement systems without having to maintain a local presence or to use a local third party to that effect. However, the advantages of having this right, along with the use that is likely to be made of it, will be seriously impaired if such a foreign investment firm is still obliged to maintain a local presence for withholding tax purposes, forcing it to use an additional intermediation layer and incur additional costs for serving its foreign clients.

This example demonstrates that failure to tackle fiscal compliance issues may diminish the positive effects of other EU measures introduced with a view to achieving a more integrated financial market.

²¹ Decided: Verkooijen, Case C-35/98), Manninen (Case C-319/02), Fokusbank (EFTA Case E-1/04). Pending: Kerckhaert-Morres (Case C-513/04), Denkvit (Case C-170/05), Amurta (Case C-379/05).

²² Reference to the MiFID: Directive 2004/39/EC, OJ 2004 L145/1.

²³ MiFID recital 48.

1.9. CONCLUSIONS

Any requirements concerning fiscal representatives in national tax legislation (whether explicit or implied) or withholding- and transaction tax-related procedures, will need to be closely scrutinised, with a view to examining their compatibility with the basic freedoms of the EC Treaty given the developing case-law of the European Court of Justice and the entry into force of the Recovery Directive (2001/44/EC).

2. WITHHOLDING TAX PROCEDURES (GIOVANNINI BARRIER 11)

2.1. INTRODUCTION

The purpose of this chapter is to identify potential inefficiencies in the procedures in place in the various EU Member States for the collection of withholding tax on income from securities and securities transactions and for granting withholding tax relief that may be available under domestic law or pursuant to double taxation treaties.

The primary focus is on national withholding taxes on income derived from portfolio investments in publicly traded securities held in national or international Central Securities Depositories (“CSDs”).

The procedures governing withholding taxes on interest under the EU Savings Directive and national withholding taxes on income from privately held securities or from associated enterprises (including the procedures for granting exemptions from withholding tax in the application of the Parent Subsidiary Directive or the Interest/Royalties Directive) are hence *not* included in the scope of this chapter.

2.1.1. Structure of this chapter

Section 2.2. "Differences in tax collection and relief procedures", gives a brief overview of the differences between the procedures for withholding tax collection and relief in the various EU Member States.

Section 2.3. "Areas not properly adapted", provides a description of the areas in which withholding tax collection and relief procedures are not adapted to the way actively traded securities are held and transferred, (including the scenario whereby securities are held by foreign accountholders in a direct account with national CSDs).

Section 2.4 "Analysis of withholding tax issues in the light of EU-law", examines more closely the facts set out in sections 2.1.-2.3. in the light of both the freedom of capital and the freedom to provide services.

2.2. DIFFERENCES IN TAX COLLECTION AND RELIEF PROCEDURES

The country reports produced by FISCO demonstrate that withholding tax collection and relief procedures vary considerably among Member States and different procedures often apply even to different classes of securities within the same Member State. Differences may be observed in all possible aspects of tax collection and relief procedures. The main differences in such procedures for domestic-source interest and dividends are outlined below.

2.2.1. Tax collection

2.2.1.1. Responsibility for deducting withholding tax

In a large number of Member States the responsibility for deducting withholding tax from domestic securities income lies exclusively with the issuer of the securities. In other Member States, this is the responsibility of the intermediaries involved in the payment of the income, whereby a distinction can be made between Member States allowing foreign intermediaries to act as withholding agents and those where only locally established intermediaries can assume such responsibilities. In Belgium, the operator of the local settlement system is the withholding agent for income on debt securities held in the “X/N clearing system”.

2.2.1.2. Timing of withholding tax deduction: withholding on accrued interest versus income distributions

One noteworthy difference is the way withholding tax is applied to interest bearing securities across Member States. In most Member States, investors holding securities will pay withholding tax on the entire amount of income distributed by the issuer on the coupon payment date or upon redemption. However, Belgium, Italy and Portugal have, in some cases,²⁴ a “*pro rata temporis*” withholding system for interest bearing securities, whereby tax is levied at source on the interest accrued upon each transfer of the securities between interest payment dates. Even though the question as to whether to levy withholding tax on accrued interest or on income payments concerns the actual substance of withholding tax rules it also dictates to a very large extent the tax collection and relief procedures. Conversely, the fact that withholding tax is rarely levied on accrued interest is most likely due to the practical difficulties with this approach in an environment where securities positions are held on a fungible basis in omnibus accounts through multiple tiers of custodians, central securities depositories and other financial intermediaries (cf. *infra*, section 2.3.1.2.1).

2.2.1.3. Reporting obligations associated with withholding tax collection

In several countries some reporting obligations must be met in connection with taxable income payments. Again, differences exist in terms of the content of reporting, the entity required to comply with the reporting obligations, the person to whom the reports must be issued and the frequency and format of reporting. In most cases, the information to be reported relates to the gross income, the tax withheld, the net income and the recipient of the income. In Portugal, however, all transactions must be reported by the withholding agent as a condition for investors to obtain tax relief. In most Member States, the reporting obligation applies only to the withholding agents. Exceptionally, this obligation may be imposed on any intermediary intervening in the payment of the taxable income (e.g. the obligation to issue dividend vouchers in the Netherlands). In some countries the reporting takes the form of paper certificates delivered to the recipient for each individual payment (e.g. dividend voucher in the Netherlands), while in others the reporting is on an annual basis to the tax authorities and the investors (e.g. France, Italy).

²⁴ In Belgium, this “*pro-rata temporis*” withholding system is only applied for securities held in the X/N-system, not in the ordinary withholding tax regime.

2.2.2. Withholding tax relief procedures

2.2.2.1. Relief methods:

Three distinct methods can be used for granting relief from withholding tax:

- "at source relief",
- "quick refund"
- "standard refund"

Under the "at source relief" procedure, income payments are made immediately, taking into account the exemptions or applicable reduced rates.

Under the "quick refund" procedure, income is initially paid net of withholding tax at the maximum rate and any refunds are made by the withholding agent before expiry of the period for transferring the withheld taxes to the tax authorities.

Under the "standard refund" procedure, refunds of withholding tax are generally requested directly from the local tax authorities.²⁵ In a few Members States, withholding tax relief can in principle only be obtained via a standard refund procedure (e.g. the relief procedures for dividends in Germany, Austria, Denmark and Luxembourg). Most member states, however, have a combination of relief procedures.

2.2.2.2. Documentation requirements for obtaining relief of withholding tax

Generally beneficial owners must provide some form of evidence to prove that they are entitled to withholding tax relief under domestic law or double taxation treaties. The type of documentation to be provided differs from country to country. At one end of the spectrum, relief can be provided on the basis of free-format information about the beneficial owners (e.g. Czech Republic) or on the basis of documentation held by the intermediary under know-your-customer rules (e.g. Germany and Austria). At the other end of the spectrum, relief can be granted only on the basis of official forms stamped by the local authorities of the investor's country of residence by the investor's auditors (Irish equities), or even by the local tax authorities of the country of investment (Latvia). Furthermore, the period of validity of the certificates varies: in some countries separate forms must be used for each claim (cf. Belgium, Netherlands), while in other countries certificates remain valid for one year (e.g. simplified procedure for French equities) or even until revoked (e.g. self-declaration to obtain exemption from substitute tax with respect to interest on Italian debt securities).

²⁵In France, refund requests must be handled by the local withholding agent that has deducted the tax.

2.2.2.3. Statute of limitations for refund claims and time needed for refunds

The period within which withholding tax refunds must be claimed varies among Member States, and even within the same Member State depending on the treaty under which the refund is claimed. In the same way the time to obtain a refund of withholding tax may vary from a few weeks in some Member States (e.g. the Netherlands) to many years in other Member States (e.g. Italy).

2.2.2.4 Tax Authority arrangements for processing refund claims

In some countries the processing of all refund claims is centralised in one office of the tax authorities, while in other Member States refund claims must be filed with the local tax office responsible for the withholding agent. In one case, refund claims are procedures that are processed by the withholding agents (France).

The complexity and administrative costs resulting from the above differences in withholding tax relief procedures often lead investors to forego the relief to which they are entitled and may discourage cross-border investment for the same reason. In some cases, these differences reflect substantive differences in the withholding tax rules or particular concerns regarding tax evasion and avoidance. In many areas, however, different approaches are taken to the same practical problems without any specific reason and there is clearly room for harmonisation and rationalisation.

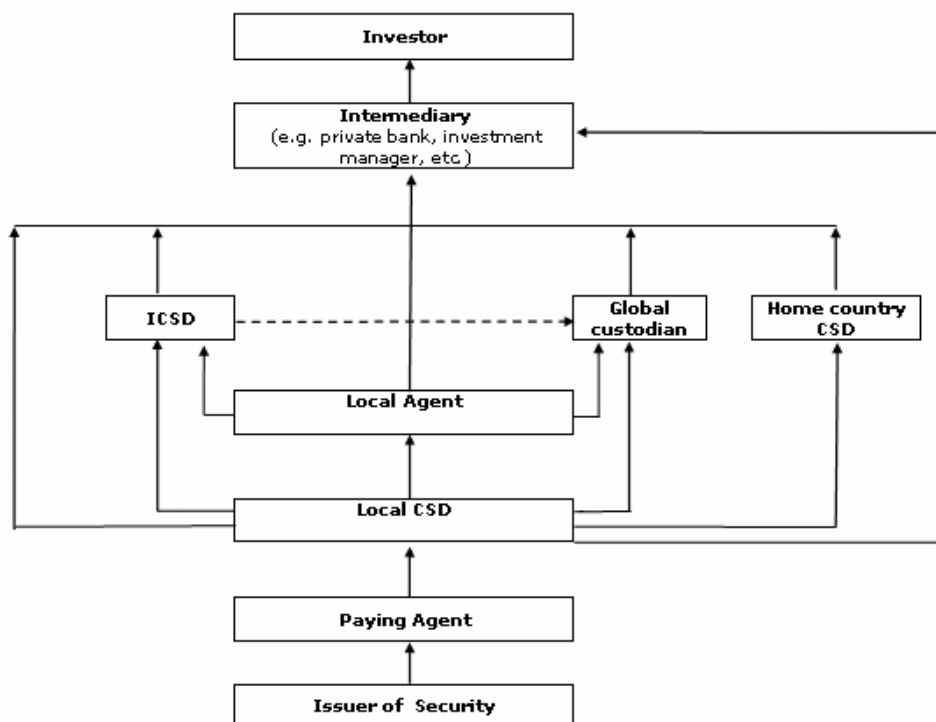
2.3. AREAS NOT PROPERLY ADAPTED

Investors and intermediaries have different options for obtaining access to a foreign market or for making cross-border securities transactions. These may:

- have direct access to a national CSD;
- make use of the services of a local agent, which will be a member of the local CSD;
- use an (I)CSD or a global custodian as a single access point to national CSDs in various countries ((I)SCDs or global custodians may have direct or indirect links with national CSDs);

At the same time issuers very often have the freedom to choose the legal and/or operational location of their securities for the purposes of the issue process.²⁶

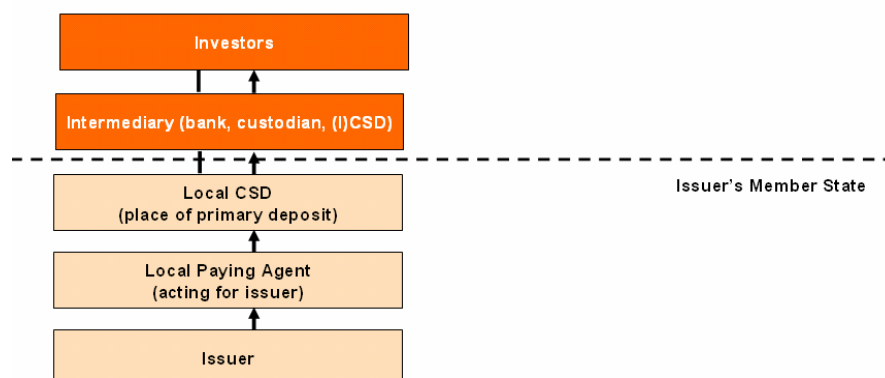
²⁶ The choice of the (location of) the CSD of primary deposit for securities may be limited by non-fiscal legislation for particular classes of securities (e.g. equities, dematerialized securities, ...)



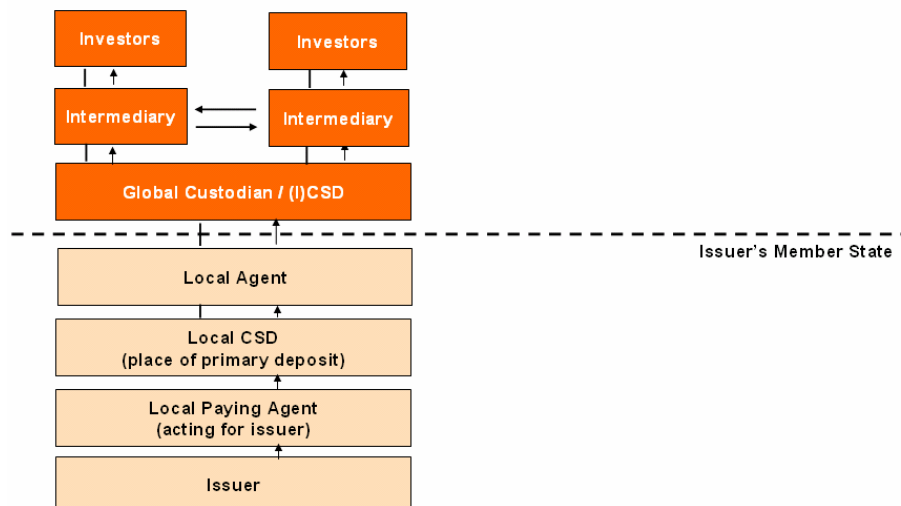
To be efficient, withholding tax collection and relief procedures should function in an equally efficient way, irrespective of the arrangement chosen by investors and intermediaries alike for cross border settlement and holding of securities. The FISCO Group has therefore not limited its analysis to barrier 11 of the Giovannini reports, but has examined more generally whether the withholding tax collection and relief procedures are compatible with the various ways in which securities may be held or transferred.

In particular the Group has examined:

- whether the procedures allow foreign investors and intermediaries to have direct access to national CSDs under equal conditions as local investors and intermediaries (cf. Giovannini barrier 11) ;



- whether the procedural withholding tax rules take into account that cross-border securities transactions may settle not only in the books of the CSD or agent of the country of investment, but also in the books of a foreign (I)CSD or global custodian; and



- whether the procedures function in an environment in which securities are held in omnibus accounts via one or more intermediaries who are interposed between the issuer of the securities.

Several areas have been identified where withholding tax collection and relief procedures are incompatible with one or more of the above arrangements.

2.3.1. Withholding tax collection procedures are not adapted to the way in which securities are held and transferred by intermediaries

2.3.1.1. Collection of withholding tax at source on dividends and interest as an obstacle to remote access to CSDs

As mentioned in section 1.8 of this fact-finding Study, Article 34 of the MiFID introduces the right of investment firms to obtain non-discriminatory direct remote access to foreign clearing and settlement systems without having to maintain a local presence or to use a local third party for this purpose.

In both of its reports on cross-border clearing and settlement arrangements in the European Union, the Giovannini Group suggests that tax rules may require foreign intermediaries to appoint a local agent or fiscal representative in order to be able to offer at source relief from withholding tax for income derived from domestic securities and thus prevent foreign intermediaries or investors from obtaining direct access to the national CSDs of the country of investment. This issue is noted as Barrier 11 to efficient cross-border clearing and settlement.

The conclusion of the Giovannini Group, that foreign intermediaries can be placed at a disadvantage in their capacity to offer at-source relief from withholding tax, is based on the following reasoning:

- investors prefer withholding tax relief to be granted at source rather than by way of a refund;

- relief at source can be granted only with the help of an entity that has formal withholding tax responsibilities (normally a bank or other financial institution);
- the majority of EU Member States either restrict such withholding tax responsibilities to entities established within their own jurisdiction or require foreign withholding tax agents to appoint a local fiscal representative to carry out their withholding tax obligations; and
- as a result, foreign intermediaries are required to appoint a local agent or a local representative to be able to offer at source relief, which may represent a significant extra cost for foreign intermediaries vis-à-vis local providers.

In several Member States certain intermediaries bear specific responsibilities in the procedures for withholding tax collection and relief. They may be responsible either for deducting the withholding tax or for determining the rates at which upstream withholding agents are required to apply withholding tax. In the latter case they are generally entitled to instruct upstream withholding agents to apply a given tax rate on income payments received, without being required to forward certificates of residence or other beneficial owner details to the withholding agent at time of payment.

Very often, foreign intermediaries are either not allowed to assume the same level of responsibilities as local intermediaries, or must appoint a local representative in the country of investment in order to assume such responsibilities. As a result, foreign intermediaries may be forced to appoint a local intermediary or a fiscal representative, either because it is explicitly required by law or because it is in practice the only workable solution to ensure that tax is collected at the appropriate rates. The FISCO Group has identified several cases where procedural tax rules prevent foreign intermediaries from obtaining direct access to the local CSD, or where such rules do allow them to obtain such access but not under similar conditions as local intermediaries. Below is a non-exhaustive overview of examples where such problems have been identified:

2.3.1.1.1. France: domestic equities and debt securities

Even if the tax rules in France do not formally oblige foreign intermediaries to appoint a local agent to ensure the collection of withholding tax on income from French securities, foreign intermediaries are nevertheless obliged to do so in practice. Withholding tax on French source moveable income must be applied by the last local entity intervening in the payment of the income (Article 75 of Annex II to the General Tax Code, D. Adm. 4-J-1341, No 15, 01.11.1995). For non-resident investors or intermediaries that make use of the services of a French agent, the latter agent will be considered the French withholding agent. Where non-resident intermediaries opt for direct access to the local CSD, the issuers of the securities or their paying agent are considered to be the withholding agent, which leads to several practical problems in the withholding tax collection process:

- Currently income payment processes for French securities are highly automated. As the withholding agent, French CSD accountholders are entitled to receive income gross of withholding tax and can fully benefit from automated procedures, as they are not required to provide any beneficial owner information to upstream intermediaries or issuers or to segregate accounts held at the CSD depending on the applicable tax

rates. Where issuers or paying agents have to act as the withholding agent the requirement to apply tax on the basis of beneficial owner documentation precludes such automation. This is especially problematic for dividends on French equities given that no single default withholding tax rate applies: dividends paid to French resident investors are exempt from withholding tax, while dividends paid to non-resident investors are subject to 25% withholding tax (with the possibility to benefit from reduced rates under double taxation treaties). In addition issuers or paying agents do not have the required information about trades effected prior to the ex date and that settled after the record date for the dividend payment, and they do not intervene in the payment of market claims processed on such trades, which prevents them to apply the correct withholding tax on such market claims.

- To obtain withholding tax relief at source, non-resident CSD accountholders would need to establish contacts with a large number of issuers and/or paying agents, while investors or intermediaries using a local agent can benefit from relief through one single access point.
- The procedures for obtaining withholding tax relief at source are designed for the specific situation where securities are held by a foreign intermediary with a French custodian and do not function properly where issuers or paying agents are acting as the withholding agent. There is a simplified procedure for granting withholding tax relief at source on dividends (BOI 4 J-1-05, 25 February 2005), which operates as follows:
 1. The foreign intermediary need only provide one single certificate of residence for each underlying beneficial owner to the withholding agent, which is valid for all payments made to a beneficial owner over one year (instead of a separate certificate for each income payment under the standard procedure). Foreign intermediaries using a local custodian will therefore benefit from relief on the basis of one certificate per beneficial owner sent to the custodian, whereas foreign intermediaries with a direct account at the CSD may be required to collect certificates for each payment and provide them to the various issuers and/or paying agents.
 2. Prior to the dividend payment, the foreign intermediary need only provide allocation information per withholding tax rate to the withholding agent. Detailed income allocation information per beneficial owner does not have to be provided to the withholding agent until three months after payment. While local custodians may make use of this provisional information to grant relief, issuers or paying agents may not be in a position to do so, as they have no practical or contractual means to recover undue tax benefits from the foreign intermediaries.
- In practice, refunds of withholding tax can only be granted through the intervention of the local withholding agent.

As a result of the above problems, procedural tax rules effectively prevent remote access to the local CSD.

2.3.1.1.2. Ireland: equities

In principle the issuer is responsible for the deduction of withholding tax on dividends from Irish equities. Certain intermediaries that are resident in Ireland or have a presence in Ireland can become an Authorised Withholding Agent (AWA) and take over the withholding responsibility from the issuing company. Intermediaries that are not resident in, or have no presence in Ireland cannot become an AWA. However, non-resident intermediaries are able to grant withholding tax relief at source if they are a Qualifying Intermediary (QI) (infra). Even though Irish tax rules do not constitute an impediment to remote access and the relief procedures have become more efficient through the introduction of the QI concept, they do not entirely ensure an level playing field between local intermediaries, who are allowed to assume withholding responsibilities, and non-resident intermediaries who are not allowed to assume such withholding responsibilities.²⁷ The main advantage of AWA status is that such agents are not required to provide any information to the issuers or segregate accounts to the CSD in order to obtain withholding tax relief whereas QI:s with direct access to the CSD will normally be required to do so.

2.3.1.1.3. Italy: domestic equities and debt securities

For dividends on Italian equities that are deposited in the CSD operated by Monte Titoli, substitute tax is to be applied by intermediaries that are admitted to the CSD or by non-resident intermediaries admitted to a foreign CSD which is in turn admitted to the CSD operated by Monte Titoli, provided they have the equities in custody (Article 27-ter (2) of DPR 600/73). Unlike Italian resident accountholders, non-resident account holders responsible for the deduction of substitute tax are obliged to appoint a fiscal representative in Italy (Article 27-ter (8) of DPR 600/73).

For interest on most debt securities, substitute tax must be levied at source by banks, brokerage companies and other authorised financial intermediaries which hold the securities in custody or by the issuers if the securities are not deposited (Article 2 (2) of LD 239/96; Article 1(b) of DM 632/96; Article 5(2) of LD 239/96). Foreign intermediaries are allowed to act as withholding agents provided they have an electronic connection with the Italian Ministry of Economy and Finance. However, unlike Italian intermediaries, they are required to appoint a fiscal representative in Italy (Article 1(b) of DM 632/96). Legally, foreign intermediaries holding Italian debt securities directly in Monte Titoli are not obliged to act as withholding agents if they do not have a direct electronic connection with the Italian Ministry of Economy and Finance. However it is not entirely clear whether, from a practical point of view, the substitute tax could be applied at all in cases where a foreign intermediary opts to hold debt securities as a direct accountholder of Monte Titoli without assuming withholding responsibilities. Most likely Monte Titoli as a CSD would not be in a position to levy the

²⁷ Even though Qualifying Intermediaries cannot assume withholding obligations with respect to Irish source dividends, they are nevertheless obliged to apply withholding tax and pay it over to the Revenue in case they should have received dividends net of withholding tax, but received the dividends gross due to delays in updating the share registers (Section 172(LA)).

substitute tax given that this applies to interest accrued upon each transfer of securities and the issuer has no information about such transactions.

2.3.1.1.4. Poland

As a result of recent legal reforms in Poland, foreign intermediaries can now become a direct member of KDPW, the Polish CSD. However, the legal uncertainty surrounding the question as to who should actually collect the withholding tax on income from securities held by remote accountholders is currently a practical barrier to remote access to the CSD.

2.3.1.1.5. Portugal: domestic securities

In Portugal, the “registering and depository entities” (i.e. the direct members of the local CSD) must act as the withholding agent on interest and dividends paid on securities issued by Portuguese entities that are legally subject to registration or deposit requirements under the Portuguese Securities Code (Article 101(3) of the Personal Income Tax Code). Under article 125 of the Corporate Income Tax Code, non-resident registering and depository entities that render such services in Portugal are obliged to appoint a fiscal representative in Portugal.

2.3.1.1.6. Spain: domestic equities and securities²⁸

With respect to income derived from the transfer of Spanish private zero coupon debt securities, the Spanish financial intermediary, charged with the transfer by the transferor is responsible for applying the withholding tax (Article 53 Ley IRNR and 11 Reg. IRNR). When redemption or transfer is made without the intervention of a Spanish intermediary, a Spanish public notary must apply the withholding tax. Issuers or financial intermediaries are not allowed to intervene in the redemption or transfer of such securities if the transferor cannot provide a certificate of acquisition issued by a Spanish financial institution, the issuer or a public notary (Article 102.3 L IRPF and 90.3 and 4 Reg IRPF; Article 53.3 L IRNR; 141.2 L IS and Article 61.7 Reg. I.S.).

With respect to dividends from Spanish equities, non-resident beneficial owners can benefit from reduced rates of withholding tax via of a quick refund procedure. However this procedure is available only if the securities are deposited with a Spanish custodian (Article 1 of Ministerial Order of 13 April 2000).

²⁸ In January 2006 the Spanish Government presented a draft for a new tax law. The draft will be discussed in the Spanish Parliament and is planned to be finally approved during 2006 in order to be in force from January 2007. The draft proposes that capital gains, interests and dividends will be charged with 18% of withholding tax. The withholding tax is planned to be applicable to all kinds of securities. Formal obligations are not going to be changed.

2.3.1.2. Withholding tax regimes designed for settlement in local CSDs with the intervention of local intermediaries

Often, withholding tax regimes are designed to function in an environment where securities issued by local issuers are held at a local CSD and/or where local intermediaries intervene in the settlement of transactions involving such securities. Such withholding tax regimes may discourage or prevent the settlement of securities transactions by foreign CSDs or intermediaries either because of the way the taxes are levied (c.f. 2.3.1.2.1.) or because the law explicitly provides for a more favourable withholding tax treatment for securities held and transfer at a local CSD (cf. 2.3.1.2.2.). No tax is collected in cases where transactions are settled without the intervention of a local intermediary (cf. 2.3.1.2.3).

2.3.1.2.1. Accrued interest realised through the transfer of securities

In most Member States, only securities-related income distributed by the issuer (typically interest payments or dividend distributions) is subject to withholding tax. However, a few Member States have tax legislation requiring tax to be applied at source on income realised or deemed to be realised on securities transactions.

Belgium, Italy and Portugal have, in some cases, a “pro rata temporis” withholding tax system for interest-bearing securities, whereby tax is levied at source on the interest accrued upon each transfer of the securities between interest payment dates.²⁹ Such a requirement creates potentially significant problems when securities settle in the books of a foreign settlement service provider.

In cases where only settlement service providers are allowed to collect withholding tax (e.g. Belgium), foreign settlement service providers holding the securities with a local CSD may be precluded or discouraged from settling taxable transactions on their books, due to the fact that the local settlement service providers need to intervene in individual taxable transactions in order to be able to comply with their tax collection responsibilities. In Italy and Portugal foreign settlement service providers are allowed to act as withholding tax agents but they must appoint a local fiscal representative, which represent an additional cost for foreign settlement service providers.

In addition, a tax regime that requires the application of withholding tax on a transaction basis could be costly and administratively burdensome. Local providers usually hold a larger portion of the securities in their country than remote providers, which means that the cost of developing systems to meet tax collection and reporting requirements may be more justifiable economically for a local provider than for a remote provider.

2.3.1.2.2. Rules that provide for a more favourable tax treatment for securities held at a recognised local CSD.

Tax rules may in some cases provide for a distinct tax regime for securities held and transferred at recognised CSDs (e.g. the substitute tax regime for dividends on equities held in Monte Titoli, or the “X/N-regime” for debt securities held in settlement systems recognized

²⁹ See also footnote 25.

by Belgian Royal Decree as X/N clearing systems). Where such recognition is reserved for local CSDs or local operators of settlement systems and where the tax regimes for securities held in such recognised CSDs may be more favourable than those applicable to securities not held in such systems, non-recognised/foreign CSDs may be at a disadvantage compared to local/recognised CSDs. For instance the eligibility criteria and formal conditions for exemption from withholding tax on Belgian debt securities are more flexible for securities held in a recognised X/N-clearing system and only credit institutions that are established in Belgium can be recognised as operators of an X/N system.

2.3.1.2.3. Withholding tax on market claims in case of short sales

Where equities are traded “cum dividend” the dividend payment date is not yet settled, the dividend will be credited to the account of the custodian acting on behalf of the seller. However, most markets have corrective procedures for such situations whereby the seller is required to compensate the buyer for the dividend (“market claims”). A specific problem may arise where a seller has purchased securities ex-dividend to meet an obligation to deliver securities cum dividend. In such cases the purchaser will also need to be compensated for the dividend by the seller. Bona-fide purchasers will generally treat the compensation received as the actual dividend and may claim withholding tax relief on it. In order to prevent purchasers claiming withholding tax relief on compensation to which no withholding tax was applied, such compensations in the case of short-sales is deemed to be a dividend for tax purposes in both France and the Netherlands and the broker/custodian/clearing member used by the seller is obliged to apply withholding tax to the compensation as if it were the dividend (Netherlands: instruction of the Ministry of Finance dated 11 August 1964, No B4/7038, BNB 1965/90; France: French tax Regulations 5, I-3-01, 9 September 2001, BOI 12 September 2001). However, it is not clear how such rules should be applied if securities are transferred without the intervention of a local intermediary. A similar rule is planned for Germany.

2.3.1.3. Tax on capital gains applied at source as a possible disadvantage for foreign intermediaries

Hungary, Italy and Spain³⁰ have tax legislation that requires tax to be applied at source on capital gains derived from securities transactions. In Hungary such a requirement is not necessarily problematic where only the local counterparties in the transactions are required to apply the withholding tax. However, in Italy and Spain (with respect to zero-coupon bonds), the responsibility for applying tax at source on capital gains lies with the local depositories or intermediaries.

In Italy, capital gains taxes may be levied according to three different regimes: the “*regime ordinario*”, the “*regime amministrato*” and the “*risparmio gestito*”. Under the *regime ordinario*, taxable investors must declare taxable capital gains in their tax returns. The *risparmio amministrato* regime may only be applied by banks, brokers and other authorised financial intermediaries resident in Italy or by permanent establishments of non-resident banks, brokers and other authorised financial intermediaries (Article 6 d.lgs. 21/11/1997,

³⁰ The law describes the tax as a withholding tax on implicit interest but since the tax applies to the difference between the sale and purchase price of the securities, it would qualify as a capital gains tax in most countries.

No461). Here, capital gains realised by non-residents on listed securities and derivative contracts concluded in a regulated market are non-taxable (Article 23 TUIR) and capital gains realised by non-residents on non-listed securities are tax-exempt if the recipients are resident in countries that allow an adequate exchange of information. Under the *regime amministrato* capital gains tax is levied by the above mentioned intermediaries on the capital gains obtained by the investor through their intervention. Therefore, investors are exempt from the obligation to file a tax return. With respect to securities held by non-resident intermediaries (including foreign (I)CSDs) with a local financial intermediary, the *regime amministrato* applies by default. Here, non-resident intermediaries, who hold listed securities belonging to non-resident investors can get relief from capital gains tax, if they declare that the customers on whose behalf they hold these securities are not resident in Italy (C.M. 26/10/1999, No.207/E). For the application of the *regime amministrato*, the local financial intermediary is required not only to keep track of taxable transactions at beneficial owner level and to record the residency of each beneficial owner but also to keep track of trade details (securities and prices), which is particularly difficult if securities are settled in the books of the foreign intermediary. Non-resident intermediaries can apply for the *regime amministrato* to be set aside. However, to do so, they must report taxable transactions to the Italian tax authorities and appoint a fiscal representative in Italy. The cost of appointing a local fiscal representative and the cost for the developing systems to meet the tax collection and reporting requirements, (given that these latter costs can be divided between a fewer number of customers), puts foreign settlement service providers at a disadvantage compared to local settlement service providers.

In Spain capital gains on zero-coupon bonds are subject to withholding tax at source. For zero-coupon bonds issued by private companies, the intervention of a local intermediary or notary in the transaction is obligatory. With respect to zero-coupon-bonds from public issuers, the local “managing entity” is responsible for the collection of the tax to (Article 33 of the LIRNR). According to Article 9 LIRNR, the local custodian of the securities is jointly liable for any unpaid taxes together with the beneficial owner. However, the tax legislation does not take account of multi-tiered holding structures interest on securities that can be transferred between beneficial owners in the books of a foreign settlement service provider, and it is unclear who must apply the withholding tax on such transactions.

2.3.1.4. Withholding tax obligations with respect to foreign source income creating a competitive disadvantage for local intermediaries vis-à-vis foreign intermediaries.

In some Member States not only domestic source income but also income from foreign securities is subject to withholding tax. In most cases, only local intermediaries that are paying the income for the immediate benefit of a taxable beneficial owner are required to collect withholding tax on this income. However in at least some Member States (Portugal, Spain) any local intermediary intervening in the payment of such income is obliged to collect withholding tax and exemptions can only be granted on the basis of certification proving the exempt status of the beneficial owners of the income. Obviously, any rules imposing an additional withholding tax burden or certification burden simply by virtue of the fact that the income is obtained through a local intermediary puts local intermediaries at a competitive disadvantage vis-à-vis intermediaries located in jurisdictions that do not impose such obligations.

2.3.2. Relief procedures are not adapted to an environment where securities are held through multiple intermediaries

Even though actively traded securities are rarely held directly by the investor with the issuers, very few Member States have adapted their tax relief procedures to today's environment where securities are held on a fungible basis in omnibus account via one or more domestic and/or foreign intermediaries. This is the case both for at source relief procedures and refunds.

2.3.2.1. At source relief procedures

Several of the country reports produced by FISCO highlight practical difficulties in connection with relief at source procedures. The problems systematically relate to the requirement that detailed information or paper-based certification on beneficial owners must be passed on through one or more intermediaries to the withholding agent prior to the payment of the income, a requirement that makes it practically very difficult to apply for relief at source when securities are held in omnibus accounts through multiple intermediaries on behalf of a large number of beneficial owners.

The root of the problem lies in a combination of the following factors:

- Very often only the issuer can act as the withholding agent for domestic source securities income or, where withholding responsibilities are given to intermediaries, not all intermediaries in the chain can act as the withholding agent (in particular the last intermediary in the payment chain, who distributes the income directly to the beneficial owner, may not be allowed to assume withholding responsibilities);
- Withholding agents can only provide relief at source on the basis of detailed information and/or certificates from the beneficial owners of the income payment;
- Intermediaries (other than the withholding agents) are not given any specific responsibility in the relief at source procedures, and consequently when securities are held through one or more intermediaries without withholding responsibilities paper based documentation on beneficial owners and detailed allocation information must be passed on through the chain of intermediaries to the upstream withholding agent.
- In practice this gives rise to the following difficulties:
 - Administrative burden: The provision of tax relief often requires the collection and validation of a large number of certificates or documents with information on beneficial owners which is a very labour-intensive and onerous process. The administrative burden associated with such procedures is increased by the fact that each country of investment has its own formal documentation requirements, so basically similar information must be provided in a different format in each of the countries of investment.
 - Timing problems: In cases where separate paper form certificates of residence must be signed by beneficial owners for each individual income payment and the certificates must be stamped by the local tax authorities of the beneficial owners' country of residence, there may be insufficient time between the dividend announcement date and the income payment date to allow the beneficial owner to provide the required

certificates, through the chain of intermediaries to the issuer prior to the income payment. For actively traded securities, moreover, securities positions held by intermediaries may change on a daily basis which may make it impossible to provide the upstream withholding agent with up-to-date information and certificates on the beneficial owners of the securities by the income payment date.

- Relief procedures that are an impediment to the automation of income distribution: in general, the distribution of income to account-holders of a CSD is processed in a highly automated way, which is only possible if all payments, or at least all the payments on securities held in the same account, can be made at the same rate of withholding tax. In the Netherlands, for instance, all dividends are paid net of the maximum withholding tax rate to the Dutch CSD which redistributes the income to its account-holders. Where issuers or paying agents act as the withholding agent, the requirement to apply tax at a different rate on the basis of beneficial owner documentation received from intermediaries precludes such automation.
- Strict liability of withholding agent and associated risks: Where intermediaries acting for the beneficial owners do not have any responsibilities towards local tax authorities in the country of investment, upstream withholding agents are forced to provide relief at source on the basis of information on underlying beneficial owners which they cannot verify. At the same time, there are not always safe-harbour rules that allow the withholding agent to avoid liability for undue tax relief. This may be particularly problematic if the withholding agent has no contractual relationship with the holder of the securities allowing it to recover undue tax benefits granted on the basis of erroneous documentation (e.g. in cases where the issuer or paying agent are the withholding agent) or if the withholding agent is an entity prohibited from taking such credit risks.

Due to the above problems, doubts are expressed in several reports about the workability of relief at source procedures when securities are held via one or more intermediaries (e.g. Belgium, Poland and the Netherlands). In some Member States relief at source is only working because local withholding agents are prepared to take on the risk of providing relief to intermediaries without requiring upfront details about the beneficial owners of the securities, even where this is required by the rules (Sweden). In other countries relief at source is in practice only granted if securities are kept in segregated accounts for each underlying beneficial owner at the level of the local CSD (Denmark).

Some Member States have introduced or are about to introduce simplified relief procedures for securities held through intermediaries:

- In Finland, new tax relief procedures have been in place since 01.01.2006, for the specific situation where securities are held by foreign intermediaries with an account operator of the local CSD. The new procedures allow the account operators at the local CSD to grant withholding tax relief at source on Finnish source dividends paid to their clients/intermediaries located in the EEA or USA, without being required to obtain beneficial owner details from these clients prior to income payment. To benefit from such procedures the foreign custodian must enter into an agreement with the account operator and be registered with the Finnish tax authorities. In the agreement the foreign intermediary must agree i) to inform the account operator of the tax domicile of the beneficial owners (and confirm that they are entitled to treaty benefits), ii) to inform the account operator of any changes to the latter information, and iii) to

provide, upon request, the name, date of birth and address of the beneficial owners and certificates of residence issued by the local tax authorities of the beneficial owners. On the one hand the new procedure clarifies the participants' liabilities for unpaid taxes. It should be noted that a foreign custodian is not liable for taxes in any circumstances, notwithstanding potential contractual liabilities. On the other hand the new procedures only address the relationship between the account operators and their direct customers. If the customer of the account operator in turn holds the Finnish equities on behalf of other intermediaries, it is possible that in some circumstances the customer of the account operator may still in practice be required to collect up-front all beneficial owner details. This in order to be in a position to meet its contractual obligation to provide such information to the account operator upon request, and to avoid the risk that the tax authorities terminate its registration for failure to provide certificates upon request. In addition the new procedure will only apply for beneficial owners entitled to a relief rate of 15% or higher under a double taxation treaty with Finland. For beneficial owners entitled to rates lower than 15%, full relief can only be provided at source if the local account-holder is in possession of full beneficial owner details prior to payment.

- France has special at source relief procedures for dividends paid to non-resident account-holders. Under these simplified procedures, non-resident intermediaries have up to three months after the income payment to provide beneficial owner details and documentation to the French withholding agent (cf. below).
- In Ireland withholding tax relief can be granted only on dividends on Irish equities where all intermediaries in the payment chain enter into an agreement with the Irish tax authorities to become a Qualifying Intermediary (QI). A QI may accept declarations of exemption or QI notifications from its direct account-holders and on the basis of such declarations and notifications, notify the upstream intermediary of the withholding tax rates to be applied, without being required to transmit the declarations and notifications received. In order to be eligible for QI status, the intermediary must, amongst other conditions, be resident in an EU Member State or in another country that has a double taxation agreement with Ireland. In addition, a QI must agree to be audited by an external auditor or the Irish tax authorities. It is unclear why the QI system is restricted to dividends.

2.3.2.2. Refund procedures

Generally, investors (or their authorised representatives) that want to obtain withholding tax relief through a standard refund procedure are required to file separate refund claims for each income payment, using a separate form for each claim. In addition, in jurisdictions where the responsibility for processing refund claims is not centralised in one office, it is not always easy to identify the competent office to which refund claims must be sent. For the above reasons, the procedures for obtaining refunds of excess withholding tax are perceived as onerous, time-consuming and costly for investors, tax authorities and intermediaries alike, and investors may feel obliged to call upon the assistance of custodians to file refund claims. If there are a large number of small income payments, the administrative cost of filing refund claims may often be higher than the tax benefits that can be obtained.

Only Germany and the Netherlands have introduced special refund procedures for securities held with intermediaries, with the aim of eliminating part of the administrative burden. Both procedures have in common that they allow (foreign and domestic) custodians to file refund claims on behalf of their clients in a standardised electronic format. The advantages of these procedures are that i) no separate refund claim for each single claimant is required, ii) (in the case of Germany only), no paper form certificate of residence need be issued by the local tax authorities of the beneficial owners' country, iii) no dividend vouchers are required, and iv) the refund process is quicker.

2.4. ANALYSIS OF WITHHOLDING TAX ISSUES IN THE LIGHT OF EU-LAW

2.4.1. Introduction

The aim of this section is to examine more closely the facts set out in sections 2.1.-2.3. in the light of both the freedom of capital and the freedom to provide services.

Where Giovannini Barrier 11 is concerned, Sections 2.1. to 2.3. describe essentially two main areas where there are restrictions regarding fiscal withholding and compliance procedures.

First, restrictions exist in respect of the actual withholding and reclaim of tax, i.e. who may act as a withholding agent and where the responsibilities lie.

Second, there are impediments to cost inefficiencies caused by the complexity of the withholding and refund procedures.

Both kinds of impediments lead to inefficiencies in the cross-border holding of securities within Europe. The Giovanni Group has made clear that the cost of cross-border holding of securities considerably exceeds the cost of domestic holding. The primary question considered here is whether these impediments lead to unjustified restrictions in the sense of the EU Treaty. Especially with respect to the second category of impediments, it is not without doubt that these impediments will result in an actual restriction. It has been established that cost inefficiencies among EU Member States arise due to the fact that many complex tax procedures govern obtaining a tax refund. These cost inefficiencies do not arise for domestic investments as these procedures to reclaim tax do not apply to resident investors. Domestic investors are usually able to directly credit the withholding tax against their individual or corporate income tax due. No extra costs will then arise as these taxpayers have to file a tax return anyway.

In order to determine whether the above mentioned impediments do in fact constitute unjustifiable restrictions on the European clearing and settlement market, it first has to be established whether they are incompatible with a European free capital market.

Although most Member States provide for a relief at source procedure, in practise only a refund is available because relief at source procedures require information and documentation that cannot always be provided in time to comply with those procedures. It is the general view of the FISCO group that the capital market would be best served if a relief at source were available for all investors. The FISCO group realises that relief at source is normally not

available to domestic residents either. Therefore, this inefficiency of the market is not caused by the unequal treatment of residents and non-residents.

2.4.2 Withholding and reclaim of tax

A) Is there an impediment?

Within the European Union, different rules apply as to who is obliged or entitled to act as a withholding agent. Some Member States only permit the issuer to act as the agent that withholds the tax of which the ultimate burden is borne by the investor. In those Member States, there is no different treatment of resident and non-resident investors or of resident and non-resident financial intermediaries.

Member States that do allow financial intermediaries to act as withholding agents can be divided into two categories: countries that only allow resident intermediaries to act as withholding agents and countries that allow both resident and non-resident financial intermediaries to act as withholding agents. In the latter case, there are examples in the Member States where a non-resident financial intermediary would theoretically be entitled to act as a withholding agent, it is practically impossible for it to do so.

In respect of withholding tax reclaim procedures, Member States apply different rules depending on which financial intermediary is entitled to claim a refund of tax on behalf of its customer. Some countries require (in theory or in practice) the appointment of a domestic intermediary to file a reclaim of withholding tax. This can be of relevance for both resident and non-resident investors.

If a foreign intermediary must rely on the intervention of a domestic financial intermediary in order to perform its activities, a breach of the freedom to provide services is clearly present.

B) Is there a justification?

ECJ Case law

It is clear that Member States are in breach of EU law if the only way to withhold tax is where solely resident financial intermediaries are allowed to act as withholding agents. Firstly, the MIFID requires remote access to the financial infrastructure for all European investment service providers. Secondly, the freedom to provide services requires Member States to give access to foreign service providers. In other words, if a non-resident service provider cannot act as a withholding agent in a given country, a non-resident investor is in practice obliged to use a resident intermediary for holding securities in that country. Clearly, such a Member State protects the market for its domestic financial intermediaries. It is not so much a question of whether foreign service providers eventually wish to act as withholding agent, but that they at least have a choice to do so. In respect of reclaim procedures, the foreign service provider usually shall provide all information necessary for the reclaim of tax. The mandatory intervention of a domestic intermediary then only results in an extra cost for the foreign investor.

In the ECJ case law on direct taxation, there are no cases explicitly concerning situations where stricter tax reclaim procedures apply to non-residents than to residents or where intervention of domestic service providers is compulsory. Nonetheless, some ECJ cases may

provide guidance on this. For instance, in *Futura*³¹ the ECJ expressed the view that Member States may require information on the basis of which the tax authorities of the source state can clearly and accurately determine that certain tax losses have been incurred in their territory. Further, it was decided in *Svensson*³² that Member States may not grant interest subsidies conditional upon whether the interest is received by a domestic financial intermediary. This condition the Court found impeding both the freedom of services and the freedom of capital as well. In *Jessica Safir*³³, the fact that an insurance taker must carry out a complex procedure to become entitled to a deduction of insurance premiums paid to a foreign insurer, deterred insurance takers from concluding contracts with foreign insurers.

Furthermore, two non-tax court cases are of importance when it comes to differences in procedures.

The first case is *Bordessa*³⁴ where a Mr. Bordessa had tried to export banknotes from Spain. At that time, a permit was required to export cash and Mr. Bordessa did not have such a permit. The ECJ then held that the requirement to have an administrative permit was not in breach of Article 28 EC or Article 49 EC, because these types of money transfers came under the freedom of capital. At that time, the freedom of capital was not fully liberalised (as it is now). It may be assumed that if the case had happened after full liberalisation the permit requirement would have been in breach of Article 56 EC.

A second case that could provide further guidance is *Ambry*,³⁵ concerning a travel agency business in France. To be allowed to operate, a travel agency was required under French law to have a licence, which was granted only if financial security was provided for refunding money to customers in the event of insolvency. If this financial security was granted by a non-French bank, this bank had to enter into a re-insurance contract with a French institution. The ECJ held that this requirement went against the freedom to provide services.

These case law examples show that when more complex requirements are placed on non-resident financial intermediaries and/or foreign investors the resulting impediments would not be reasonably justifiable in a liberated capital market.

Other arguments

It is assumed that Member States would invoke two arguments to justify the above restrictions.

As far as withholding tax agent responsibilities are concerned, it can be expected that Member States claim that evidence is needed that tax is actually withheld and that information exchange, in practice, is not a reliable source of such evidence. This evidence issue could, however, be overcome by -for instance- remittance of the tax by the issuer rather than a financial intermediary. Furthermore, under the Mutual Assistance Directive, Member States are able to request withholding tax information from the competent authority of other Member States. While Member States may rightly require such information to verify withheld and reclaimed taxes, mutual cooperation required on the basis of the Mutual Assistance Directive would be preferable to restrictive national laws.

³¹ C-250-95)

³² P.Svensson and L. Gustavson v. Ministre du Logement et de l'Urbanisme, C-484/93.

³³ Jessica Safir, Case C-118/96.

³⁴ Bordessa and other, Cases 358/93 and 416/93, 1995, ECR I-361

³⁵ Andre Ambry vs. Tribunal de Grande Instance Metz, C-410/96, 1998, ECR I-7875

Another argument could be that it may be difficult for a Member State to recover wrongly withheld tax or incorrectly reclaimed taxes. Member States will have to prove that domestic financial intermediaries are required to remit any taxes which are incorrectly refunded. If for instance the beneficial owner or issuer is liable for this, the recovery argument probably cannot be allowed. Secondly, even if domestic rules apply to domestic service providers that guarantee recovery, it might be questionable whether this argument can still be upheld under the EC Recovery Directive. Similarly to the case with the Mutual Assistance Directive, practical imperfections of the Recovery Directive should be solved between the Member States instead of including provisions in national law that lead to infringements of the Treaty freedoms.

Based on the examples cited above, it is the observation of the FISCO group that impediments based in national law restricting foreign service providers from assuming withholding tax agent responsibilities and/or performing withholding tax procedures, will probably lead to unjustifiable restrictions of the freedom to provide services and the freedom of capital.

2.4.3 Cost-inefficiencies and complexity of fiscal compliance procedures

A) Is there an impediment?

Where a resident investor invests in domestic securities, a refund of withholding tax is normally obtained through a tax credit against individual or corporate income tax. No extra formalities have to be fulfilled to receive a refund as these taxpayers will have to file a tax return in their country of residence.

Where foreign investors are subjected to additional administrative burdens, the complexity of the reclaim rules among the different Member States makes cross-border investment less efficient and less attractive compared to domestic investment. Foreign investors are confronted with higher costs for holding similar securities. Therefore, it will be more difficult for domestic companies to attract capital from non-residents. In addition, it is easier and less costly for non-residents to invest in domestic securities than it is for foreign investors. It can be concluded that the freedom of capital is restricted due to the complex tax procedures imposed on to foreign investors.

B) Is there a justification?

ECJ case law

It is a fact that part of the extra cost of the cross-border holding of securities is caused by the (-difference in-) fiscal compliance procedures in the Member States. This leads to the lack of a level playing field in the European capital markets. Where tax reclaim procedures imposed on foreign investors are more burdensome (whether in magnitude and/or complexity) than those applicable to residents, this may lead to an unjustifiable restriction on the freedom of capital.

Even though the ECJ seems to have drifted away from the traditional "discrimination" concept and nowadays rather applies a "restriction" approach whereby different treatment of residents and non-residents has become less important, it may be wise to establish whether residents and non-residents are in a comparable situation. The ECJ has stated in among others

Schumacker³⁶ and Wielockx³⁷ that those situations are generally not equal. However, if there is no objective difference between those two in a specific situation, then residents and non-residents are considered comparable. It has recently be stated in the EFTA Court Case on FOKUS Bank ASA³⁸ that the mere fact that resident shareholders have general tax liability in their home state while non-resident shareholders have only limited liability to tax in the source state is not sufficient to prevent the two categories from being considered as comparable situations. Arguably, one may consider that in respect of withholding and reclaim of sourced tax, no difference exists between residents and non-residents. Thus both should be subject to an equal administrative burden in respect of a similar tax.

As already mentioned above, except for Futura and Svensson the ECJ's case law on direct taxes has not extensively dealt with differences in administrative procedures of direct taxation. There are other cases that may be relevant, such as the cases Ambry and Bordessa mentioned earlier. Further, it is interesting to note to a pending case in the Netherlands whereby a Belgian resident exceeded the deadline under the double taxation treaty between Belgium and the Netherlands for claiming a refund of dividend withholding tax.³⁹ The Dutch Attorney-General has concluded that the two year deadline under the treaty is in breach of the freedom of capital because

1) a Dutch resident has 5-years to file a refund claim and

2) most Dutch double taxation treaties have a deadline longer than 2 years (mostly 3 years). In other words, European law is not adequately considered in the bilateral tax treaty concluded between the Netherlands and Belgium.

2.5. CONCLUSIONS

- The country reports produced by the FISCO work demonstrates that withholding tax collection and relief procedures vary considerably among Member States and that different procedures often even apply to different classes of securities within the same Member State. In some cases, these variations reflect differences in the substantive withholding tax rules or particular concerns about tax evasion and avoidance. In most cases, however, different approaches are taken to the same practical problems without any specific reason and there is clearly room for rationalization as regards the fiscal compliance procedures.

³⁶ Schumacker C-279/93

³⁷ Wielockx C-80/94

³⁸ EFTA Court, 23 November 2004, Case E-1/04, pt. 29. See also ECJ in Royal Bank of Scotland, C-311/97, pt. 29 whereby it is acknowledged by the ECJ that the mere fact that a resident has full liability to tax and a non-resident has only a limited liability to tax in the source state does not lead to anon-comparable situation of those two taxpayers. However, AG Geelhoed seems to make a distinction between non-residents who are subject to an income or corporate tax and non-resident that are only subject to a source tax. Question then will be how to treat Member States where the source tax is a advance levy of an income or corporate tax with respect to residents. Conclusion in Test Claimants in Class VI of the ACT group litigation (Pirelli, Essilor, Sony), Case C-374/04.

³⁹ Opinion AG Wattel in Supreme Court 6 September 2005, No. 41568

- The complexity and administrative costs resulting from the above differences may lead investors to forego the relief to which they are entitled and may discourage cross-border investment for the same reason.
- In the view of the FISCO Group, the optimal withholding tax collection and relief procedures:
 - have sufficient audit and enforcement possibilities for local authorities to ensure the proper collection of withholding tax;
 - allow for the appropriate tax relief to be applied at source without excessive documentation requirements and without exposing issuers, intermediaries and investors to unnecessary risks and costs;
 - work in an equally efficient way, irrespective of the location in which securities are held or transactions settled (local versus foreign intermediary or CSD) and irrespective of the investment structure or settlement arrangements chosen by the investors and intermediaries (direct versus indirect access); and
 - ensure equal treatment of foreign and local intermediaries.
- None of the Member States have tax collection and relief procedures in place that meet all of the above criteria for all types of securities.
 - Several cases have been identified whereby procedural tax rules de facto prevent foreign intermediaries from obtaining direct access to the local CSD, or at least do not allow them to obtain such access under similar conditions as local intermediaries;
 - The procedural tax rules do not always take into account that securities transactions may settle outside in the books of a settlement service provider established outside the country of investment;
 - Although some Member States have taken initiatives to adapt their at source relief procedures to the environment in which securities are held through foreign intermediaries or have introduced rather efficient refund procedures for intermediaries it appears that very often withholding tax relief procedures are not adapted to an environment in which securities are held in omnibus accounts through multiple tiers of intermediaries.
- In some cases, the efficiencies that were identified apply equally to all involved parties. In some other cases, procedural tax rules put foreign intermediaries and/or investors at a disadvantage compared to local intermediaries and/or investors and may constitute a violation of the EC Treaty.

3. TRANSACTION TAX PROCEDURES (GIOVANNINI BARRIER 12)

3.1. INTRODUCTION

The objective of this chapter is to present some findings on transaction tax procedures in the EU Member States with regard barrier 12 in the Giovannini Report:

‘Any provision requiring that taxes on securities transactions be collected via local (settlement) systems should be removed to ensure a level playing field between domestic and foreign investors.’

This chapter assembles information provided by members of the FISCO Working Group, at its second meeting in June 2005, on transaction tax procedures, for securities markets in the EU Member States and Switzerland⁴⁰.

The transaction tax procedures are summarised. Relevant descriptions of administrative procedures for the collection of tax are included. Observations are made regarding the impact of transaction tax procedures in terms of restrictions for non-resident service providers in the markets studied.

3.1.1. Definitions

When using the phrase “transaction tax”, this fact-finding study refers to any tax or duty imposed by any state on the sale, purchase, transfer or registration of a financial instrument. In general, it will be broadly based, but will exempt some instruments or transactions. It can be ad valorem (i.e. a percentage of the purchase price) or fixed (i.e. a specific charge). It can be levied on transactions by resident, on domestic transactions or on both. Sometimes (but not always), transactions outside national boundaries are not subject to tax. Where such extra-territorial transactions are subject to tax, there may be considerable enforcement problems. Transaction taxes can be levied on buyers (as in the UK), sellers or both. Broadly speaking, one may say there are two types of transaction taxes: transfer taxes on the sales, exchanges or transfers of shares and capital duties on the issues of securities.⁴¹ It should be noted that taxes or duties imposed on the issue of securities may contravene the EU Capital Duty Directive.

3.1.2. Background

Transaction taxes have been utilized by a number of EU Member States with mixed results. Tax authorities have found the imposition of stamp duties or security transfer taxes to be

⁴⁰ Switzerland has been included for comparative purposes.

⁴¹ See presentation by Steven McGrady at the first Fiscal Compliance Expert’s Group Meeting of 15 April 2005

useful at certain times, but many have discontinued their use, primarily because of market conditions.

The following 11 jurisdictions in the European Union currently have a transaction tax: Belgium, Finland, France, Greece, Ireland, Italy, Malta, Poland, Portugal, Slovenia and the U.K. Some Member States such as Germany, Netherlands and Sweden used to have transaction taxes but have since abolished them. Since transaction taxation in Spain is generally not applicable to securities transactions, Spain is not included in this section of the report. (For information on Spain, however, see section 4.4.1.5).

For purposes of this study, transaction taxes not applied to stock exchange-based securities trading may not be relevant. This is the case for Italy, Finland, Malta, Slovenia, Poland and Portugal. A number of European countries appear to be selective in the application of transaction taxes. Such is the case with the United Kingdom, where tax is chargeable on securities issued in the UK, regardless of the participants.

The application of transaction taxes within the EU varies, as shown by the following market descriptions.

3.2. MARKETS

3.2.1. Markets with transaction taxes applied to stock exchange-based securities trading, settlement and clearing. (Belgium, France, Greece, Ireland and the UK.)

3.2.1.1. Belgium

Belgium has a stock exchange transaction tax (TOB) laid down by the Code of Taxes Assimilated to Stamp Duty (CTASD) and further regulated by the royal decrees issued for its implementation. The TOB is applied to transactions made with “public securities”, i.e. securities that can be traded on a regulated market (whereby it is not required that the securities are effectively listed or traded on a regulated market) (Art. 120, 1° and 3° CTASD). The TOB is considered due when the underlying contract for a transaction is concluded or executed in Belgium and the transaction is effected through a Belgian professional intermediary.

The transactions covered are:

(1) Transactions in securities with separate taxation on sale, purchase and transfer at the following rates:

- 0.70 per mille: for transactions with securities of public debt (Belgian public debt as well as foreign public debt), bonds of Belgian or foreign companies, parts of investment funds and assimilated rights issued in Belgium;
- 1.70 per mille: for transactions with any other type of security (in practice, mostly shares).
- Purchase of capitalisation shares: 0.5 % (unless issued by institutions for collective investment); in principal, change of distributions shares into capitalisation shares is not considered a taxable event.

- Repurchase of capitalisation shares (that is, shares that do not pay dividends but only accrue the income in the reserves of the investment company) by an investment company (tax only due on the transfer to the investment company): 0.5 %. The repurchase of distribution shares is not subject to TOB.

The ceiling is €500 except for transactions involving capitalisation shares where the ceiling is €750. No TOB is applied to the repurchase of distribution shares.

A special regime for the purchase of capitalisation shares applies for the period between 1 January 2006 and 3 January 2008. During this period, there will be no TOB on switches from capitalisation to distribution shares. As of January 2008, the stock exchange tax on disposals of capitalisation shares will again be 0.5%.

The TOB does not apply to the following:

- transactions in Belgian government issues (including, OLO's and public Treasury certificates) and short -term debt certificates of the National Bank of Belgium;
- transactions in certificates of deposit and treasury certificates issued under the law of 22 July 1991.
- transactions made by non-residents.
- transactions done by certain Belgian institutional investors, including investment funds, for their own account.

Besides the TOB the following transaction taxes apply in Belgium:

1) Stamp duty

A stamp duty of € 0,15 applies to receipts delivered in Belgium by credit institutions or brokers to individuals for deposit or delivery of securities (art 11 Stamp duty Code).

2) Tax on the delivery of bearer securities (art. 159 and following CTAT)

A tax of 0.6 % applies to delivery of Belgian or foreign 'fonds publics' 'openbare fondsen'. Deliveries to credit institutions, brokers and other equivalent professionals are not subject to tax.

3) Tax on prolongations, Article 138 and following CTAT)

A tax of 0.85 per mille applies to prolongations of public securities ('openbare fondsen', 'fonds publics') made through a professional intermediary acting on account of third parties or for his own account.

The tax applies to each party to the transaction. Exemptions are comparable (but not completely identical) to those applying to the above mentioned tax on security exchange transactions (TOB). They apply to:

- deliveries without the intervention of a professional intermediary;
- deliveries to non-residents of foreign '*fonds publics*' held in open custody with Belgian intermediaries;

- deliveries abroad or to a non-resident of Belgian public debt securities issued in a foreign currency;
- International institutions, which have a variety of exemptions.

Observations

In the case of Belgian transaction taxes, there appear to be no restrictions on foreign settlement providers. Belgian debt securities enjoy a more beneficial transaction tax treatment than foreign debt securities. Non-resident holders have numerous exemptions not available to Belgian holders. Use of a Belgian intermediary, may in some cases trigger the application of transaction tax, whereas no such tax would apply if a foreign intermediary were used.

3.2.1.2. France

Transfer tax or *l'impôt de bourse* is applied to the purchase and sale of all securities, whether spot or forward, that are exchange traded in France. The tax is charged at 0.3 % on the amount of each transaction equal to or under € 153,000 and 0.15 % on the remainder above this amount. The amount of tax is capped at €610 per transaction. The tax applies to:

- fixed-income securities other than convertible debt or obligations that are indexed or provide income based on the profits of the issuer;
- transactions in securities issued by companies whose stock exchange market value does not exceed € 150 million (EURONEXT provides periodic lists of such securities);
- profit - participating securities;
- securitisation bonds or mutual funds (*fonds communs de créance*);
- initial public offerings or transactions related to increases of capital;
- certain repurchase transactions – as of 1 January 2006;
- shares of companies listed on the Nouveau Marché as well as those traded on the former regional exchanges are totally exempt from transfer tax.

Article 980 *bis* of the French tax code specifies further exemptions to this transfer tax:

- counterparty transactions made by brokers
- the sale and purchase of all security classes by non-residents.

Collection

French brokers are responsible for the collection and reporting of transfer tax. This applies to the accounts of French residents, including transactions made by French residents on foreign stock exchange markets.

Observations

Brokers licensed in France are required to collect and report transaction tax if they have French residents who are engaged in stock purchase and sales. Use of foreign brokers may have been one result of this collection procedure, (see Section 4.4.1.6).

3.2.1.3. Greece

Greek regulations provide for transfer taxes on the sale of Greek debt securities or equities transacted on the stock exchange. This transfer tax is equal to 0.15% of the sale price of listed securities.

This tax is applicable to all investors (residents and non residents).

Collection

The local brokers are responsible for collecting the transfer tax and remitting it to the local clearing and settlement system, which in turn pays the tax to the stock exchange

Observations

As the administration of the Greek transfer tax is handled locally, foreign settlement service providers may not be able to play a role.

3.2.1.4. Ireland

Ireland charges stamp duty on instruments which convey or transfer property. Such instruments include those which effect transfers on the sale of registered securities in Irish companies or equitable interests in Irish securities as well as contracts for the sale of equitable interests in Irish securities.

Where transfers of securities use a recognized "dematerialised" transfer system ("relevant system"), such as CREST, the operator-instruction is deemed to be the executed instrument of conveyance or transfer of such securities and the date of execution is taken to be the date the operator-instruction is generated.

The rate of ad valorem stamp duty levied on the transfer of stock or marketable securities is 1 % of the consideration. Subject to various conditions, companies may obtain relief from stamp duty in the event of consolidations, mergers and transfers between associated companies. Relief is also available to qualifying professional and institutional investors including stock exchange member firms (market maker relief, broker dealer relief, stock lending relief).

Collection

The payment of stamp duty is mandatory. Unlike in the UK, once an instrument liable to duty is executed, the duty must be paid and any unpaid duty will be an enforceable debt due to the State.

The person liable to account for stamp duty in a transfer of securities (the “*accountable person*”) is the purchaser or transferee, (except in a voluntary disposition where both parties are liable).

In general, the chargeable instrument is to be stamped and the duty paid to the Irish Revenue Commissioners (“*IRC*”) directly, though not later than 30 days after execution of the instrument. There are penalties for failure to pay stamp duty on time and unstamped documents are generally inadmissible in court.

CREST operates a system whereby the Irish *ad valorem* stamp duty (at a rate of 1 % of the consideration) is in principle levied on all relevant transactions of Irish equities in its books (i.e. between CREST members) unless a relief or exemption is invoked by one of its members. CREST ensures stamp duty collection, payment and reporting thereof to the IRC. The operation of such a system was a requirement stipulated in the relevant Irish Uncertificated Securities Regulations in order to allow CREST to transfer legal title to securities. CREST has also entered into an agreement with the IRC setting out the conditions and the criteria to operate a stamp duty functionality.

Observations

Clearing and settlement systems (other than CREST) are not regulated by the same regulations as CREST (they are not operators of a relevant system). The current Irish regulations treat such systems (when they hold securities through CREST) as any other CREST member. Consequently, they are considered as accountable for all external deliveries of Irish equities into their account in CREST. It is unclear though whether as a technical matter transfers within clearing systems effect transfers of equitable interests in the underlying securities because the nature of the clearing systems’ obligation to their members is not necessarily that of trustee. There are no special stamp duty rules relating to transfers of interests in Irish shares within such systems. There exists no "Irish clearing service charge" (as in the UK), nor is there a legal framework for clearing systems to start collecting stamp duty on transactions that take place in their books and pay and report this to the IRC.

This in practice poses a number of problems:

- it is unclear whether transfers in the books of clearing and settlement systems are subject to Irish stamp duty and if so (i) who must account for it and (ii) how an accountable person must comply with its stamp duty obligations; and
- relief that could be applied on transactions that take place in CREST could be questioned or rejected by the IRC when onward transactions (which are linked with transactions on which relief is claimed) are carried out on the books of a clearing system.

3.2.1.5. United Kingdom

The UK charges the following taxes on securities transactions:

- a.** Stamp Duty Reserve Tax (SDRT) on an agreement to transfer a “chargeable security”. (the “Basic SDRT Charge”). The rate of tax is 0.5% of the consideration under the agreement.

“Chargeable Securities” includes shares of UK incorporated companies, certain convertible or otherwise non-plain vanilla debt of UK incorporation companies, and warrants to acquire shares in UK incorporated companies. Depository Receipts for non-UK securities are not chargeable securities. If Stamp Duty is paid on the transfer (see (v) below), SDRT is not charged.

b. SDRT on the issue or transfer of chargeable securities (as defined above) to a clearing system (the “Clearing System SDRT charge”). The rate of tax is 1.5 % - known as the “season ticket” charge because once in a clearing system the Basic 0.5 % charge is not payable. CREST is not regarded as a “clearing system”. A clearing system may (subject to agreement with HMRC) elect not to be treated as a clearing system by agreement with HMRC. If it elects then this 1.5 % charge is not payable but the basic SDRT charge becomes payable on any agreement to transfer the security. It appears that such elections may be dependent upon the type of account in which the securities are held – so that the transfer of securities held in the designated account will be subject to the 0.5% duty.

There are exemptions for agreements to transfer chargeable securities in depository receipt form, within a clearing system, and for certain bearer securities.

c. SDRT on the issue or transfer of chargeable securities to a depository receipt issuer who issues a depository receipt representing the right to the securities of (the “Depository Receipt SDRT Charge”). The rate of tax is 1.5 %. As with the Clearing System SDRT charge this is a “season ticket” charge since, once within depository receipt form, the Basic SDRT Charge is not charged on an agreement to transfer the securities. There are exemptions for certain bearer securities.

d. Stamp Duty on a bearer instrument (“Bearer Instrument Duty”) The rate of tax is 1.5 %. It is charged on the document not the transaction. Although it is an older tax than the SDRT, the 1.5 % Bearer Instrument Duty also acts as a season ticket charge exempting from the Basic SDRT Charge agreements to transfer bearer instruments on which Bearer Instrument Duty has been charged, and from the Clearing System SDRT charge and the Depository Receipt Charge the 1.5 % which would otherwise be payable under those charges on instruments on which Bearer Instrument Duty was charged. There are exceptions for bearer instruments in currencies other than Sterling, and for loan capital. The charge applies to bearer instruments issued by UK incorporated companies at the time of their issue, and to other bearer instruments on the occasion of their first sale in the UK.

e. Stamp Duty at 0.5 % on any document by which shares or securities are transferred (“Stamp Duty”) This is the oldest of the five relevant taxes. Like Bearer Instrument Duty it is a charge on a document rather than on a transaction, but unlike the three SDRT charges and Bearer Instrument Duty it is not directly assessable on any person: SDRT and Bearer Instrument Duty can be collected through the courts from the person liable to pay; Stamp Duty cannot be.

Stamp Duty can therefore be said to be a “voluntary tax”, but there are two routes by which HMRC ensure its collection: first a document may not be registered (or recognized by a UK Court) unless it is duly stamped (so that the share transfer will not be registered by a UK company unless someone has paid the duty), and secondly, if the stamp duty is not paid, SDRT will generally be payable under the Basic SDRT charge.

Any transfer document that has something to do with the UK will potentially be stampable but generally it will only be stamped if it has to be registered in the UK.

There is an exemption for plain vanilla loan capital. Transfers of Bearer Instruments (and Depository Receipts) will normally be by delivery (rather than by document) and so will not fall under the tax. Transfers within clearing systems, even if in documentary form, will generally not require registration within the UK – so even if they relate to UK shares they will not need to be stamped to be recognized as effective.

Collection

1. The Basic SDRT Charge

The person primarily liable for the Basic 0.5% SDRT Charge is the transferee of the relevant securities. Inland Revenue may collect the charge from the transferee directly. Other persons however are made “accountable” for the charge. They are liable;

- to give notice of the charge to tax; and
- to account for the tax to HMRC

If, however, an accountable person shows he has taken all reasonable steps to recover the tax from the transferee he is relieved from liability to account for the tax (this however can be a difficult hill to climb).

The “accountable person” is broadly the first person to exist on the following waterfall:

- the stock exchange member acting for the transferee;
- the stock exchange member acting for the transferor;
- the dealer acting for the transferee;
- the dealer acting for the transferor;
- the transferee.

For transactions undertaken in the UK, the tax is generally collected by CREST, which is made responsible to report transactions and pay the collected SDRT for HMRC.

Where transactions are undertaken through clearing systems other than CREST which have elected not to be treated as clearing systems, the terms of the clearing system’s agreement with HMRC will provide for the clearing system to be treated as the “accountable person” and be responsible for collecting the SDRT.

2. The Clearing System SDRT Charge

This is the liability of the clearing system operator unless the operator has no UK PE or is not UK resident and the securities are transferred to its nominee – in which case the nominee is liable for the tax.

Where a clearing system elects to be treated as not being a clearing system no liability would arise under this heading.

3. The Depository receipt SDRT Charge

This is the liability of the issuer of the depositary receipt or (where the issuer is not UK resident and has no UK PE) its nominee (if it uses one).

CSDs are considered as “clearing services”, unless they make separate arrangements with Inland Revenue. A transfer made through a clearing service will be charged a 1.5% SDRT when the initial transfer is made into the account. Subsequent transfers within the account of the CSD do not attract duty.

A CSD which directly arranges with the HMRC to account for transfers between the CSD participants at the standard 0.5% rate will be subject to documentation requirements and will be responsible for the collection and reporting of tax liabilities.

Relief for types of purchasers cited above, such as firms trading on their own accounts on a recognized stock exchange in securities that are “regularly traded” may be able to claim exemption from stamp duty reserve tax.

CREST provides for the possibility to have multiple accounts for CSDs which are for use as a clearing service and a member which is acting in a capacity with direct accountability to Inland Revenue for stamp duty reserve tax.

Observations

In relation to paperless transactions, the obligation imposed upon any system operator to collect taxes will give rise to compliance costs. The compliance costs will, however be the same, whether the operator is in the UK or outside the UK - save in relation to any obligation imposed on a non-UK operation to appoint a UK tax representative.

In relation to transactions requiring the execution of documents of transfer and the payment of duty on those documents, a non-UK based person will have somewhat greater postage costs in arranging for the documents to be stamped but that cost should not be significantly greater.

There is no provision which expressly requires these taxes to be collected only through UK situated persons.

However, the legislation permits HMRC, as a condition for permitting a clearing system to “elect”, to impose upon a non-UK resident clearing system with no presence in the UK an obligation to appoint a person (a UK tax representative) with a UK establishment to be responsible for the payment of the SDRT which would arise on transactions undertaken by the “elected” system. The representative must be personally liable for the tax. It should be noted that the condition to appoint a UK tax representative is a condition put in the regulations which the HRMC may impose, but does not necessarily impose on non-resident CSDs.

This requirement would, it is suggested, not be necessary if HMRC could enforce taxing rights against non-UK persons in their jurisdiction of residence. It is unlikely, however, that the Directive 77/799/EEC on Mutual Assistance would be applicable in this instance since Stamp Taxes do not appear under the United Kingdom scope of taxes in Article 1(3). There may be a question regarding whether or not the Bearer Instrument Duty is permissible given the provisions of the Capital Duty Directive (which prohibits duty on the issue of securities), and whether Bearer Instrument Duty and the Clearing System SDRT Charge are compatible with the free movement of capital rights in the EU Treaty.

3.2.2. Markets with transaction taxes not applied to stock exchange-based securities trading, settlement and clearing. (Finland, Italy, Malta, Poland, Portugal and Slovenia.)

3.2.2.1. Finland

The transferee of securities is liable to pay transfer tax under the Transfer Tax Act (varainsiirtovero/1996). Some public institutions, such as the government and the Bank of Finland, are exempted from the transfer tax.

The tax rate is 1.6 %. The tax base is the transfer price.

Collection

The dealer in securities is obliged to recover the tax from the transferee. Besides the transferee, the tax may also be recovered from a dealer in securities.

Observations

According to the Transfer Tax Act the tax is exempted, if the transfer of securities has been made in a regulated market operated by a Stock Exchange. In compliance with established legal practice, the tax exemption is deemed to apply to the transfer of securities regardless of the domicile of the Stock Exchange. For example disposals of standard-derivative securities are exempted from transfer tax, provided that the transaction takes place in a country of the European Economic Area, at a controlled, regulated market.

3.2.2.2. Italy

There are no longer any stamp duty or turnover taxes payable for securities transactions on regulated markets in Italy. There is however a stamp duty imposed by the government for domestic off-market transactions alone and this tax is payable by private investors, intermediaries and institutional investors alike. Transactions in domestic stock executed abroad are not subject to stamp duty.

Collection

On average the tax is levied at 0.14 % of the transaction's consideration. All off exchange transactions in Italy have to be reported to the stock exchange within five minutes and the stock exchange has 60 minutes to communicate this information to the market. Off-exchange transactions are covered by the concentration rule applied by Consob (Commissione Nazionale per la Societa e la Borsa) Italy's financial regulatory authority. Stamp duties for off-exchange transactions are collected by the brokers and paid directly to the Italian Revenue.

Observations

As the transaction tax in Italy does not apply to securities traded on stock exchanges, it does not play any significant role in settlement and clearing where the present report is concerned.

3.2.2.3. Malta

Under Maltese tax law a “*duty on documents and transfers*” is applicable on every document for the transfer of any marketable security *inter vivos* to or from any person resident in Malta, if this transfer is executed in Malta. This tax is due at the rate of 0.2 % (two liri for every one hundred liri or part) on the amount of the consideration or the real value, whichever is the higher, of the marketable security transferred. Marketable securities are deemed to be any stock, debenture, bond and any interest in any company or corporation and any document representing the same.

Collection

An exemption applies to the acquisition and disposals of marketable securities effected by or issued by the following persons:

- collective investment schemes holding a collective investment scheme licence under the Investment Services Act;
- persons holding an investment service licence issued under the Investment Service Act, and whose activities comprise the provision of management, administration, safekeeping or investment advice to collective investment schemes as defined in the aforesaid Act;
- international trading companies as defined by the Income Tax Act;
- companies whose ordinary share capital, voting rights and rights to profit are substantially held by persons who are not resident in Malta and are not owned or controlled directly or indirectly by persons resident in Malta. Such company has been determined by the Commissioner as having the majority of its business interests outside Malta.

Observations

The stamp duty is applicable on documents whereby a transfer of marketable securities is effected outside of Malta at the same rate and condition as it were applicable on the transfers effected in Malta, but only if the use of these documents is made in Malta. A document is deemed to be made use of in Malta, where it is produced before a court, arbitrator or referee as evidence or is produced before any person or authority in Malta for its enforcement or registration.

As it appears that the Malta transfer tax is applicable only to Maltese residents and is not necessarily administered by local clearing system, this case would not appear to present a significant compliance barrier or cost.

3.2.2.4. Poland

Early in 2001, the Stamp Duty Act was replaced by two new acts: the Stamp Duty Act and the Tax on Civil Law Transactions Act (PCC).

Stamp Duty

Stamp duty is now charged on applications, permits, certificates and excerpts issued by a public body and on documents related to appointment of a proxy, bills of exchange and transportation documents but no longer on contracts of sale and other acts in civil law.

PCC

The tax on civil law transactions (PCC) is charged on legal procedures, contracts of sale or exchange, loan agreements, company statutes and a number of other contractual arrangements. It applies to transactions, which concern assets located or rights executed in Poland and the purchase of assets located or rights executed abroad by a Polish individual or company if the transaction takes place in Poland.

Examples of the charges are as follows:

- company statutes (as a % of capital): 0.5%;
- other property rights (e.g. securities, shares) 1% of market value.

Collection

The sale of securities to brokerage houses and banks conducting brokerage activity and the sale of securities through brokerage houses and banks conducting brokerage activity is exempt from PCC.

Observations

Under the Public Trading in Securities Act (further “PTS Act”) the securities admitted to public trading (also on Warsaw Stock Exchange) may exclusively be traded on a regulated market through companies or banks conducting brokerage activity, foreign investments firms or foreign legal persons conducting such an activity. Thus, a security which is traded on the WSE is, in general, exempt because of fulfilling the legal condition from the PCC Act. However the transactions concluded outside the WSE and under intermediation of brokerage houses or banks will be tax exempt as well.

It is not clear whether the exemption referred to above applies if the sale of securities is operated via a non-Polish brokerage house (or bank providing such services) as there are no binding explanations issued in this respect, by the Polish authorities. Although we could logically sustain such an approach since the PCC Act makes no direct reference to only Polish entities, one must be aware of the risk that the tax authorities could be reluctant to easily approve such an approach.

3.2.2.5. Portugal

Stamp duty (Imposto do selo) is imposed on certain transactions concerning securities in Portugal. The legal basis for this duty is to be found in two instruments: DL No 12700 of 20 November 1926 approving the Regulation on stamp duty, and DL No 21916 of 28 November 1932 approving the general table for stamp duty. These two instruments have been regularly amended (usually once a year) but in 1999 it was republished by Law No 150/99 of 11 September, which was amended by Law No 176-A/99 of 30 December; Law 3-B/2000 of 4

April: Law 30-C/2000 of 29 December; Law No 109-B/2001 of 27 December. It was again republished by Decree-Law nr. 287/2003 of 12 November.

Collection

In some cases there is a fixed rate (specific rate), while in others the rate is proportional. The many documents and deeds subject to duty include the following:

1. Bills of exchange: 5 %.
2. Bills and all kinds of documents payable or receivable, including correspondence, other than cheques drawn on national territory: 5 %.
3. Bank transactions:
 - a. interest charged by banking establishments, notably on discounting bills of exchange and treasury bills, loans, credit accounts and additional capital and on credit being paid off: 4 %.
 - b. premiums and interest on bills drawn, bills receivable on another party's account, national drafts or transfers, and in general on all commission charged, save commission on the provision of guarantees: 4%.
 - c. commission on the provision of guarantees (% of the guarantee): 3 %.
 - d. other commissions on financial services: 4 %.

Stamp duty is paid using a special form. The Portuguese CSD is not involved in the collection of the Stamp duty.

Observations

As the stamp duty is not collected via automated clearing, this case would not appear to be relevant for the purpose of this study.

3.2.2.6. Slovenia

Transfer taxes are collected for the registration of the transfer of the shares of a limited liability company in the court register.

Collection

The court duty is charged to the limited liability company when the transfer of shares is made.

Observations

This case does not appear to be significant for the purpose of this study.

3.2.3. Markets outside the EU

3.2.3.1. Switzerland

The issue of shares in a Swiss corporation is usually subject to a 1% securities issue tax (there are exemptions, in particular for merger and merger-like transactions). If a Swiss-registered securities dealer is either party or intermediary to a sale of shares, usually a 0.15% (Swiss shares) or 0.3% (foreign shares) securities transfer tax is levied. However, there are an increasing number of exemptions from securities transfer tax for certain types of transactions.

Debt instruments are not subject to Swiss securities issue tax or securities transfer tax unless they qualify as a collective fund raising scheme. Collective fund-raising schemes such as bonds (*Obligationen*) and medium-term notes (*Kassenobligationen*) are subject to securities issue tax (bonds: 0.12% of the nominal value for each year of the maximum duration; medium term notes: 0.06% of the nominal value for each year of the maximum duration) if they are issued by a Swiss issuer. Furthermore, securities transfer tax is levied if a Swiss-registered securities dealer is either party or intermediary to a sale of bonds or medium-term notes.

Collection

Members of the Swiss exchange are subject to the Swiss federal law on stamp duty of 27 June 73 (StG). However, remote members of the exchange were in the past not covered by this act and were free to trade Swiss securities without paying the stamp duty charges paid by local members. This competitive advantage was ended when the National Council of the Swiss Parliament amended the federal law governing stamp tax in March 1999. The amendment effectively made the remote members subject to the stamp duty law of 27/6/73 (StG) for all their transactions in Swiss domestic securities, effective April 1, 1999. Under the new law, remote members are exempted from paying stamp duty on trades made for their own account. However, they must now pay stamp tax on customer orders and transactions executed on behalf of foreign-domiciled securities dealers. The Swiss exchange is responsible for monitoring and collecting these stamp duties.

Observations

The Swiss exchange rules on stamp duty formerly offered an advantage for foreign members, which have subsequently been modified to restrict the exemption for foreign members to dealings with proprietary assets. This case was included for comparative purposes as the transaction tax, similar to Crest in the UK, is collected electronically.

3.3. CONCLUSIONS

- Currently, eleven Member states have some form of a transaction tax on the transfer of securities.
- In most Member States, the responsibility to collect the transaction tax lies with the parties to the trade or their agent. Only in very few Member States is the responsibility to collect transaction taxes on securities transactions imposed on the settlement service providers.

- Tax rules that impose tax collection responsibilities on settlement service providers do not always take into account that securities transactions may settle in the books of several local or foreign settlement service providers and do not allow all such settlement service providers to collect transfer taxes under similar conditions. This issue may in the first place be important to the relevant tax authorities whose concern is lost revenues. However it may also put certain settlement service providers at a competitive disadvantage to others. These disadvantages may result from:
 - The legal uncertainty whether transactions settling in their books are subject to the transaction tax,
 - The absence of a legal framework for such settlement service providers to collect transaction taxes on transactions that take place in their books and pay and report this to the relevant tax authority.
 - The denial of exemptions of transaction taxes, if transactions linked to the one for which exemption is requested, are not settled by a settlement service provider with tax collection responsibilities.

4. DO SECURITIES TRANSACTION TAXES AFFECT MARKET LIQUIDITY?

4.1. INTRODUCTION

This chapter differs markedly from the other chapters of this Report. Essentially, it gathers views from the existing literature and the opinions of FISCO Members on the effects of transactions taxes on liquidity in securities markets. In so doing it also considers specific country experiences. No attempt is made here to produce a comprehensive survey of the entire literature in this area. This would have been impossible in the time available. This chapter does not claim to be an original work, but it usefully collates and summarises the views of the FISCO experts within the field of the securities transactions markets.

The first Giovannini Report acknowledged the existence of tax-related barriers impacting more generally on the efficiency of cross-border securities transactions. It states that:

“Several tax-related barriers have been identified as impacting more generally on the holding and transfer of securities across borders rather than on the clearing and settlement process. While these barriers are not a specific focus of this report, they are relevant to the broader debate on the efficiency of cross-border securities transactions within the EU. Transaction taxes can be a barrier to cross-border securities trading to the extent that [they] reduce the liquidity of markets. This situation would arise where the tax applies to either stock lending and/or taking title to securities as part of collateral arrangements. For example, several Member States apply a transaction tax on the transfer of securities, whether by way of sale, loan or collateral arrangements. In some instances, a transaction tax is applicable to activities other than purchases/sales of securities and imposes costs to the investor as he takes (legitimate) evasive action.”⁴²

In fact, the effects of transaction taxes on liquidity are by no means limited to stock lending and collateral arrangements. They impact on a wider range of transactions including straightforward purchases.

Whilst the primary focus of the FISCO Group is on specific tax procedural impediments to cross border settlement of securities highlighted in barriers 11 and 12 (relating to withholding tax and transaction tax procedures), the Group cited the above passage in the first Giovannini Report at its second meeting on 15 June 2005, in establishing the need for further work regarding the wider substantive issue of how and to what extent transaction taxes form barriers to cross-borders securities trading by reducing the liquidity of markets. This issue is not confined to cross-border trading; it is relevant to purely domestic trading as well.

It is also acknowledged that the effects of transaction taxes within a particular market are very difficult to isolate. This is because there are a number of variables operating within a market

⁴² The Giovannini Group, Cross-Border Clearing and Settlement Arrangements in the European Union, Brussels, April 2003, pages 52-53.

at any one time which can potentially affect liquidity indicators e.g. structural and policy changes may affect the price and volume of transactions. Sometimes, information from outside the market can dramatically affect volume movements e.g. a takeover announcement. Such an announcement may affect not only the specific target company's stock but also the trading of similar companies in the same industry sector.⁴³

Given this, the FISCO Group believe that a more helpful approach in attempting to isolate the effects of transaction taxes on market liquidity is to look at the experiences of countries where transaction taxes have been abolished or introduced, increased or decreased in the recent past i.e. where there has been a change. Hopefully, it will then be easier to identify and measure the impact of the transaction tax itself. Assuming other variables remain more or less constant, it is anticipated this will provide some empirical evidence of the effects of transaction taxes in markets.

The countries analysed are the Member States: Finland, Netherlands, Sweden, UK and more briefly, Spain, France and Germany. The countries outside the EU which have been considered are India and Japan.

4.2. SCOPE OF ENQUIRY AND DEFINITIONS

The current enquiry is: To what extent do transaction taxes affect liquidity in securities markets? To understand this question, it is necessary to define the three terms in question – transaction tax, liquidity and market.

4.2.1. Transaction tax

The phrase “transaction tax” is used here to refer to any tax, fee or duty imposed by any state on the sale, purchase, transfer or registration of a financial instrument. In general, it will be broadly based, but will exempt some instruments or transactions. It can be ad valorem (i.e. a percentage of the purchase price) or fixed (i.e. a specific charge). It can be levied on transactions by residents, on domestic transactions or on both. Sometimes (but not always), transactions outside national boundaries are not subject to tax. Where such extra-territorial transactions are subject to tax, there may be considerable enforcement problems. Transaction taxes can be levied on buyers (as in the UK), sellers or both.

Broadly speaking, one may say that there are two types of transaction taxes: transfer taxes on the sales, exchanges or transfers of shares and capital duties on the issues of securities.⁴⁴ (This report is focused on the effects of the first type of transaction tax upon liquidity. Further work could be done in relation to the second type. For example it might be helpful to consider the special 1.5% charge in the UK on the transfer on issue of shares into depository receipt or clearance service mechanisms.)

⁴³ For further discussion of the point that the effects of transaction taxes on liquidity could vary depending upon market conditions, see 'Effects of Securities Transaction Taxes on Depth and Bid-Ask Spread', D.Y Dupont and G S Lee, May 2003, Institute for Advanced Studies, Vienna, Economic Series 132.

⁴⁴ See presentation by Steven McGrady at the first Fiscal Compliance Expert's Group Meeting of 15 April 2005

Transaction taxes exist in several countries around the world including Belgium, Finland, France, Greece, Ireland, Italy, Malta, Poland, Portugal, Slovenia and the UK and outside Europe in India. However, “public policy initiatives on securities transaction taxes have led to the reduction or elimination of such taxes in countries such as Germany, the Netherlands and Sweden.”⁴⁵

4.2.2. Liquidity

The term liquidity is used in various ways, but all relate to the availability of, accessibility to, or convertibility of an asset into cash. Thus, a market is said to be liquid if the instruments it trades can easily be bought or sold in quantity, with little impact on market prices i.e. participants can easily convert their positions into cash⁴⁶.

It is often said that, to be liquid, a market should enable traders to buy and sell the traded instruments *quickly* and *at low cost*. Conversely, “illiquidity” is defined in terms of the cost of immediate execution.

At a basic level, the liquidity of a market may be analysed by considering the following:

- Volume of transactions - a more liquid market has more transactions taking place in it than a less liquid market.
- Time – a more liquid market is one in which transactions take place faster.
- Type of investor – a more liquid market is one in which investors of all sizes can participate e.g. institutional investors and individuals. A more liquid market would be accessible to individuals.
- Listings – one may assume that a more liquid market attracts more listings.
- Academics⁴⁷ have identified the following components for measuring liquidity:
 - The bid-ask spread. This is the difference between the current bid and the current ask for a given security. The ‘bid’ being the highest price any buyer is willing to pay for any given security at a given time and the ‘ask’ being the lowest price at which any investor or dealer is willing to sell a given security or commodity.⁴⁸
 - Depth i.e. the volume of transactions necessary to move prices
 - Resiliency i.e. the speed with which prices return to equilibrium following a large trade.
 - Diversity i.e. the degree of diversity among market participants (Persaud 2001).

⁴⁵ ‘Liquidity, Asset Prices and Financial Policy’, Amihud and Mendelson, Financial Analysis Journal Nov/Dec 1991

⁴⁶ www.riskglossary.com

⁴⁷ E.g. Kyle (1985)

⁴⁸ www.advfn.com/money_words

4.2.3. Market

In theory, the effect of transaction taxes can be examined upon liquidity in the context of any securities market. However, quoted markets are easier to study than private transactions. This is because data is more readily accessible in respect of dealings in markets where stock is quoted and traded through recognized exchanges.

All of the examples in this study are therefore confined to dealings in markets where stock is quoted and traded through recognized stock exchanges. Nevertheless, it is acknowledged that transaction taxes may affect private transactions between individuals outside the quoted public market.

The FISCO Group see no reason why in principle the effects on liquidity should not be the same for securities transactions outside the quoted markets in private off market transactions. If the collection and enforcement mechanisms are adequate then the consequences of transaction taxes are likely to be the same.

4.3. EXISTING LITERATURE ON THE EFFECTS OF TRANSACTION TAXES

The references below from the existing literature are not exhaustive. However, the comments and extracts are useful summaries of the thoughts some leading writers have expressed on the topic.

Liquidity is not however the only measurement by which one may assess the efficacy of a securities market. And, while the merits and de-merits of liquidity are not a central focus of this report, it is worth briefly mentioning why other commentators have argued that liquidity is important.

Amihud and Mendelson⁴⁹ show liquidity to be an important factor in asset pricing. Furthermore, others argue that liquidity affects investor confidence as investors prefer to invest their capital in liquid investments that can be quickly and inexpensively realised when necessary. Overall, it is assumed by many writers that liquidity is generally regarded as a desirable attribute, although that it is only one of a number of qualities by which a market is assessed and may from time to time be inconsistent with or ancillary to other objectives.

Maureen O'Hara has commented on the considerable mass of literature that exists regarding liquidity. She notes that there are a diversity of views regarding its role and impact as either a "virtue" or a "vice." She presents three theories of liquidity. Firstly, the traditional economics view of liquidity as destabilising. Secondly, the more positive microstructure view of liquidity as a positive attribute for both traders and markets. And finally, a new view of liquidity based on uncertainty aversion.

It should be observed that some believe that liquidity is not a virtuous component of a market, a view which may be derived from Keynes, and later, Tobin. For them, it leads to short-

⁴⁹ Liquidity, Asset Prices and Financial Policy, Amihud and Mendelson, Financial Analysis Journal Nov/Dec 1991

terminism and instability. By contrast, at the microstructure level, liquidity is viewed as enhancing market stability.⁵⁰

The interdependence between transaction taxes and market liquidity is discussed by Amihud and Mendelson in their paper, ‘Liquidity, Asset Prices and Financial Policy.’ For them, it is clear that an interdependence exists:

“Securities transaction taxes make capital markets less liquid by increasing the cost of trading. There is clearly an immediate increase in cost due to the tax being paid. In addition, because the tax makes the provision of liquidity more costly, it reduces the supply of market-making services (immediacy and liquidity). The resulting decline in trading volume reduces market depth and increases the price impact of large orders and the decline in available quotes increases search costs and brokerage fees. The effect of the tax on the total cost of liquidity may be greater than that implied by the tax rate, given its detrimental effect on market liquidity.

The effect of securities transaction taxes on stock returns is, according to our model, a function of the stock’s liquidity: The higher the liquidity, the greater the effect of a given tax rate, given the clientele effect [Broadly, this is the idea that in equilibrium, assets will be allocated to different investor clienteles: the more liquid assets will be allocated to short-term investors, while the long-term investors will hold the less liquid assets.]. Because liquid stocks have greater market value and because these stocks are more sensitive to declines in liquidity, the tax is likely to have a preponderant impact on large, liquid stocks.

We calculated the effect of the proposed STET [securities transaction excise tax] on the expected returns for a large sample of NYSE stocks (using 1980 data), assuming that the tax would not increase any other illiquidity cost component.⁵¹ We found that a 0.5 per cent tax would increase the value-weighted average annual return on NYSE stocks (adjusted for beta) by 1.3per cent. This represents a considerable increase in the cost of capital. The effect on stock prices depends on the stocks’ required returns and growth rates; for a set of representative values, the expected decline in the value-weighted price on NYSE stocks was 13.8 per cent. An apparently small 0.5per cent tax can have a sizable effect on stock values and returns.”⁵²

The FISCO Group did not come across any literature that expressly denies the existence of a relationship between transaction taxes and liquidity. However, it is interesting to note the analysis of those who commend transaction taxes.

A summary of the arguments put by proponents of securities transaction taxes is provided in the ‘Literature on securities transaction taxes’ section of the IMF paper entitled, Securities Transaction Taxes and Financial Markets:

⁵⁰ Liquidity and Financial Market Stability, Maureen O’Hara, National Bank of Belgium Working Papers- Research Series, Cornell University May 2004

⁵¹ Y Amihud and H Mendelson, “The Effects of a Securities Transaction Tax on Securities Values and Returns”, Mid-America Institute for Public Policy Research, 1990

⁵² In particular, we assumed no increase in brokerage fees following the STET, which makes the 0.5 % tax rate equivalent to a 0.356 % increase in the bid-ask spread. Partial financial support for this study was provided by the Business School Trust Faculty Fellowship at Stanford University

“Opinion is divided on the merits of securities transaction taxes. Many proponents of STTs advance the following propositions:⁵³

- *The contribution of financial markets to economic welfare does not justify the resources they command. During a given time period, the resources that change hands in financial markets far exceed the value of the underlying or “real” transactions.*
- *Many financial transactions are highly speculative in nature, and may contribute to financial or economic instability.*
- *Market instability, including crashes, enriches insiders and speculators, while the costs are borne by the general public.*
- *Financial market activity increases inequalities in the distribution of income and wealth.*
- *STTs can be an important and innovative source of revenue for the financing of development.*

From this perspective, it is argued by some that governments ought to tax financial transactions in order to discourage destabilising speculation that can threaten high employment and price stability, as well as to raise revenue. Higher rates - they argue – should be levied on short-term transactions, since these seem to benefit primarily market intermediaries and not “real” users. The massive volume of financial transactions in well-developed modern markets would – they reason- allow substantial revenue to be raised by imposing very low tax rates on a broad range of transactions. It is not surprising that a number of governments around the world have succumbed to this temptation, all the more so as such taxes have a certain popular appeal.”

None of the above views seem to expressly suggest that transaction taxes do not actually affect market liquidity.

As part of the Impact Assessment⁵⁴ on a possible post-trading Directive, the European Commission carried out an econometric study to find out whether or not a reduction in transaction costs in equity trading would have a positive and significant impact on overall GDP growth. The study indeed confirmed this thesis, showing that a decrease in transaction costs (for whatever reason) would lead to an increase of the liquidity in the equity markets, with positive consequences in terms of lowering the cost of capital and thus increasing investment and GDP.

More specifically, the study concludes that a 10% reduction in transaction costs would increase liquidity by approximately 3%. Moreover, over a 10 years period, this initial reduction in transaction costs could translate into an average increase of 0.3% in real EU GDP with a 95% probability that the increase would be between 0.1% and 0.6%. Given the narrow scope of the study (only equities are considered) and the fact that the study does not take into account supply side effects (especially possible increases in total factor productivity) there is a good chance that the increase could be even bigger.

⁵³ See, for example, Tobin (1984), Summers and Summers (1989), Stiglitz (1989), and Eichengreen, Tobin, and Wyplosz (1995).

⁵⁴ Chapter 5: The benefits of integrated and/or consolidated post-trading systems.

The conclusions of the analysis carried out in the study can also be applied to the case of taxes: since different taxes represent part of transaction costs, their reduction (or elimination) would lower trading costs and therefore, through increased liquidity, lower costs of capital and increase investment and GDP.

As we shall establish later (in section 4.4.1.4 which looks at the position in the UK), whilst it is relatively uncontroversial that there is a causative link between the existence of transaction taxes on the one hand and the price of securities and the volume of trading on the other, the degree of the causal link is controversial and dependent upon other factors too. Opinions on this issue differ.⁵⁵

4.4. COUNTRIES

The following countries are analysed: *Member States*: Finland, Netherlands, Sweden, UK and, in brief, Spain, France and Germany. *Countries outside the EU*: India and Japan.

4.4.1. Member States;

4.4.1.1. Finland

In 1992, Finland abolished stamp duty on transfers of securities through stock markets. The Finnish Stamp Duty Act was then abandoned and replaced by the Transfer Tax Act (varainsiirtovero/1996). Under the provisions of the latter, transfers of securities through the Stock Exchange remained exempt.⁵⁶

In observing the effects of the abolition of the Finnish transaction tax it is necessary to appreciate that Finland was in a deep recession during the early 1990s i.e. at the time of the abolition. As a consequence, individuals were, at the time, highly cautious with their investment activities.

According to the preamble of the bill concerning the abolition of stamp duty on transfers of securities through stock markets, the purpose was on the one hand to improve the possibilities for public companies to acquire their own capital and on the other hand to kick-start the share markets. It is clear that the abolition of stamp duty in Finland led to a number of positive changes in the securities market. For example, the number of transactions on the Helsinki stock exchange in 1993 was more than three times the number of trades that took place in 1991.

⁵⁵ For example, The Volterra Consulting Limited report for M&G Limited, suggests that investors are at least 2-3% worse off when trading in markets where transaction taxes are imposed. The report also suggests listed companies are 3-4% less valuable and that there is evidence that the existence of a transaction tax does not reduce volatility in markets. (Stamp Duty on Share Trading: The Economic Impact, A Report for M&G Limited, Volterra Consulting Limited, September 2001).

4.4.1.2. The Netherlands

On 1 July 1990, the Dutch transaction tax was completely abolished. It had originally been introduced as a successor to stamp duty, which itself dates back to the nineteenth century. According to the explanatory memorandum of the Dutch Lower House of Parliament, the Dutch transaction tax served no goal other than to contribute to the National Treasury.⁵⁷

Under Dutch law, transaction tax was levied on the purchase and sale of shares by a stockbroker carrying out his or her business within the Netherlands. The broker withheld the tax from the purchaser and seller. The transaction tax was levied at a rate of 0.12%. From 1 January 1987, a maximum amount of 1200 guilders per transaction was introduced. The intention of this measure was to limit the outflow of business in Dutch shares to stock markets outside the Netherlands where no transaction tax was levied. It appeared however that even after this measure, a substantial amount of the trade in Dutch shares found its way to foreign markets, particularly the London stock market.

To prevent loss of income as a result of the abolition, it was decided that the commission on the issue of domestic loans would also be abolished. A combination of these measures should not result in additional expenditure.

The abolition was intended to improve the international competitiveness of the Netherlands stock market, which should have in turn, strengthened the position of Amsterdam as a financial centre. There were however (a few) voices within the Dutch Lower House that feared that the abolition of the Dutch transaction tax would lead to higher interest rates, unstable exchange rates and financial instability in general. From the explanatory memorandum of the Dutch Lower House, however, it appeared that the greater part of the Lower House did not share this fear. The wider general opinion was in fact that the abolition of the transaction tax would create a more efficient financial market in Amsterdam, which would contribute to a much stronger and stable financial market.

However, larger investors did not just choose London because of the Dutch transaction tax. Lack of liquidity was often cited as a reason for these major investors to choose London instead of the Amsterdam stock market. As a result of the low volume of transactions on the Amsterdam stock market, investors ran the risk that transactions of somewhat substantial sums would interfere with the listing.

4.4.1.3. Sweden

Sweden's experience with transaction taxes lasted just over 8 years. The first measure was announced in October 1983 and the tax was finally abolished in December 1991.⁵⁸

As its commence, the Swedish transaction tax was charged at 1% on stock brokers and/or investors trading in more than SEK 500,000 worth of securities a year.

The history of the introduction of the Swedish transaction tax is interesting and is noted in Habermeier and Kirilenko's paper (2003):

⁵⁷ Marierose Kouwenberg.

⁵⁸ IMF Staff Papers, Securities transaction Taxes and Financial Markets – Karl Habermeier and Andrei A. Kirilenko (2003)

“The initiative to impose financial transaction taxes came from the Swedish labour sector in 1983. The labour sector did not claim that trading in financial markets led to inefficient outcomes. Rather, according to Umlauf (1993), in the opinion of the labour sector “the salaries earned by young finance professionals were unjustifiable ... in a society giving high priority to income equality,” especially given the seemingly unproductive tasks that they performed. On this basis, the Swedish labour sector proposed to levy taxes directly on domestic brokerage service providers.”

In 1986, the tax rate on stock transactions was doubled.⁵⁹ According to an investigation made by the professional and industrial organization “Tjänsteförbundet”⁶⁰, the number of transactions on the Stockholm stock exchange increased up until June 1986. In July 1986 a temporary decline in the number of transactions was registered. Thereafter there was an increase in August 1986 and a continuously high number of transactions in September and October 1986. During those two months the turnover rate was about 800,000,000 shares per year. The following nine months saw a decreasing number of transactions. In June 1987 the number of transactions was about 600,000,000 shares per year. This was a decrease of almost 10 % compared to the turnover rate in 1985. In 1986, when the Swedish transaction tax was doubled, the trading in some shares suffered from a considerable decrease over a period of twelve months (Tjänsteförbundet, pp. 2-3).

In a report by the Swedish Securities Dealers Association in November 1989, the following conclusions were drawn with regard to the effects of Swedish transfer taxes on the stock market:

- Strongly reduced trading for stock brokers against their own trading stock, meaning a prohibitive “fee” for those brokers that took their own positions in order to give investors good service when trading in smaller blocks and less stability in fixing prices on the market, especially for less traded securities; increased difficulties and costs for the market making in the over- the-counter trading (OTC) and increased difficulties in trading shares other than shares in the most traded stock;
- Increased transfer of trading to countries other than Sweden since the Swedish transfer tax (at its highest level) meant 3-5 time higher costs for trading in Sweden than for making the same transaction in London or New York. The trading outside of Sweden in Swedish shares was already (then in 1989) larger than on the Swedish market.
- More difficulties and higher costs for Swedish companies to raise capital in Sweden and from abroad, decreased turnover/trading and therefore higher risk exposure for investors and other small share investors (reference is here made to the report by Lindgren and Westlund 1988 which conclude that an increase in trading of 150 – 300 % could be assumed if the transfer tax was to be abolished completely).

⁵⁹ According to Habermeier’s and Kirilenko’s paper in which the section on Sweden is based on the studies by Umlauf (1993) and Campbell and Froot (1995): “Continuing pressure from the labour sector compelled the Parliament to double the tax rates in July 1986 and broaden its coverage in 1987.”

⁶⁰ Tjänsteförbundet was in this context working for an exemption from the Swedish transaction tax for foreigners dealing with Swedish securities. In order to do so they started an investigation in order to elucidate the trading in Sweden and abroad on certain shares in large Swedish enterprises. The aim was to demonstrate the structural displacements that took place after July 1986 due to the doubled transaction tax on shares. The Swedish transaction tax then meant that transaction costs in Sweden were higher than in London and New York and lead to the result that foreign investors became less interested in trading Swedish shares on the Stockholm Stock Exchange. (Material received from the Swedish Securities Dealers Association.)

The success of the tax in generating revenue was miserable. Habermeier and Kirilenko observe that:

“The revenue performance of the tax was disappointing. According to the Finance Ministry of Sweden, the government collected SEK 820 million in 1984, SEK 1.17 billion in 1985, and SEK 2.63 billion in 1986. This accounted for 0.37, 0.45 and 0.96 per cent of the total revenue for the corresponding years. After doubling the tax rates the government was able to collect SEK 3.74 billion in 1987 and SEK 4.01 billion in 1988. This accounted for 1.17 and 1.21 per cent of the total revenue.⁶¹ Thus, a 100 per cent increase in the tax rate resulted in a 22 per cent increase in revenue.”⁶²

The weak performance of the tax can be partly attributed to the widespread avoidance that was taking place. According to Habermeier and Kirilenko’s paper, foreign investors avoided the tax by placing their orders with brokers in London or New York. Domestic investors avoided it by first establishing off-shore accounts (and paying the tax equal to three times the round-trip tax on equity for funds moved off-shore) and then using foreign brokers. It seems domestic investors were happier to pay a one-off toll charge.

Furthermore, there was a mass migration of stock trading volume from Stockholm to other financial centres. For example, Habermeier and Kirilenko note that:

“following the doubling of the tax, 60 per cent of the volume of the 11 most actively traded Swedish stocks migrated to London.⁶³ The migrated volume represented over 30 per cent of all trading volume in Swedish equities. By 1990, that share increased to around 50 per cent. According to Campbell and Froot (1995), only 27per cent of the trading volume in Ericsson, the most actively traded Swedish stock, took place in Stockholm in 1988.

Following the abolition of the tax, some trading volume came back to Sweden. According to Campbell and Froot (1995), 41 per cent of the trades in Ericsson took place in Stockholm in 1992. Overall, the proportion of the trading volume in Sweden increased for almost all equities in 1992. That year, 56 per cent of all trading volume in Swedish equities took place in Sweden.”

Habermeier and Kirilenko conclude:

“The Swedish experience highlights the following points. First, investors avoid the tax by finding or creating close substitutes. Since the brokerage business is very competitive, finding a close substitute for brokerage services off-shore was not very costly. However, the markets do not necessarily move off-shore, if close substitutes are available domestically. For example, trading in bonds did not move off-shore, but shifted to debentures, forward contracts, and swaps. Second, markets suffer greatly following the imposition of the tax. Even very low tax rates on fixed-income instruments led to an 85 per cent decline in volume in the first week after the tax was imposed compared to its pre-tax average. The fixed-income options market virtually disappeared. Third, after the removal of the tax, the trading volume gradually comes back across all previously taxed assets.”

⁶¹ By contrast, tobacco taxes accounted for 1.26 and 1.37 % of the total revenue collected in 1987 and 1988, respectively.

⁶² IMF Staff Papers, Securities transaction Taxes and Financial Markets – Karl Habermeier and Andrei A. Kirilenko (2003)

⁶³ See Umlauf (1993).

Clearly, therefore, Sweden had a very negative experience with transaction taxes, leading to a quick reversal of the decision to impose them. In terms of liquidity measurements, there is clear evidence of huge changes in the volumes of stock traded on the Stockholm markets.

Several writers have commented on the experiences of Sweden and cited them as an example of where transaction taxes have severely distorted market activity.

4.4.1.4. UK

Stamp duty and Stamp Duty Reserve Tax (SDRT) in the UK are transfer taxes applied to dealings in UK equities only. Where SDRT is paid, stamp duty is not normally also due, and vice versa. The general rate of tax levied on share transactions is 0.5%.

Despite a number of attempts by UK industry to encourage the UK government to abolish stamp duty, the tax remains in force. However, it is both interesting and relevant to consider two UK experiences:

1. The introduction of Intermediary Relief in 1997.
2. The development of the Contracts for Difference Market.

Intermediary Relief

Intermediary relief was introduced in 1997. This relief is available for all recognized intermediaries for the purchase of chargeable securities on exchanges. Relief is provided under sections 80A and 80B of the 1986 Finance Act in relation to stamp duty and under sections 88A and 88B of the 1986 Finance Act in relation to SDRT. These provisions exempt from tax the purchase of chargeable securities by an intermediary recognized as such by the relevant exchange, with respect to regularly traded chargeable securities on that exchange. The purpose is to exempt only dealers, so the exemption is not available to financial institutions and other investors.

The period following the introduction of the relief provides important empirical evidence about the effects of transaction taxes on market activity. This was noted by the combined London Stock Exchange / The Hundred Group of Finance Directors and OXERA Consulting Ltd⁶⁴ study which also points out:

“...because Stamp Duty⁶⁵ is, in general, only applicable to transactions involving UK-registered shares, it is possible to observe the differential impact on different types of shares being transacted by, approximately the same group of market participants using the same market mechanisms and infrastructure. This makes it easier to isolate the impact of the change in the Stamp Duty regime from other changes taking place simultaneously.”

⁶⁴ London Stock Exchange/The Hundred Group of Finance Directors ‘Impact of Stamp Duty on Cost of Capital of UK Listed Companies’ July 2nd 2001, OXERA

⁶⁵ Although technically, stamp duty can apply to non-UK registered shares where they are transferred by documents executed in the UK, the point made here really refers to SDRT. SDRT is paid on ‘chargeable securities.’ Chargeable securities are broadly, securities issued by UK corporations. Securities in non-UK incorporated companies are only ever exceptionally ‘chargeable securities’ for SDRT purposes e.g. where shares of a non-UK company are paired with the shares of a UK company.

The study went on to test the hypothesis that *“the change in the Stamp Duty regime resulting from the introduction of intermediary relief had a permanent impact on the share prices of UK incorporated companies relative to foreign companies listed in the London system.”*

The study’s conclusion is summarised as follows:

- *“The null hypothesis that the announcement in July 1996 of the change in the Stamp Duty regime has no impact on the price of the relevant securities can be confidently rejected. Indeed, the divergence of the performance of the two groups is wide, at 8% of share price.”*

Further interpretive points are noted below:

- *“the change in the tax base rather than the tax rate means that the reduction in transaction costs arising directly from the tax change cannot be measured directly. The average decrease in direct per-transaction costs may not have been particularly large. However, there may have been additional impacts on liquidity independent of direct cost changes as more market intermediaries were brought into the tax exemption...Although a general reduction in Stamp Duty would not have exactly the same impact on trading as the removal of intermediaries from the tax base, this event does still indicate that there would be a significant impact on the share price of UK companies, and that this impact would be larger than a simple scaling of the previous events when that tax rate has been changed.”*

In summary, the study asserts that the introduction of the relief affected share prices which in turn affected liquidity (as we have defined above).

The conclusion that the existence of a transaction tax depresses the price of securities and thereby to some extent reduces liquidity is relatively uncontroversial.⁶⁶ It may well be accepted by tax authorities. Beyond this, however, it is difficult to make categorical assertions. Various researchers (including those who have campaigned for the abolition of UK stamp duty and SDRT) have attempted to estimate the size of the effect and published figures suggesting for example, that the 0.5% charge in the UK depresses the price by 5.6%⁶⁷. But it is far from clear that the Governments which imposed these taxes would necessarily accept such a high multiplier to arrive at a discount (i.e. the idea that at the time of sale the buyer would factor in ten future transactions (in addition to its immediate purchase) to give a total discount of 5.6 %).

⁶⁶ For further discussion see ‘Stamp Duty on Shares And Its Effect on Share Prices,’ Steve Bond, Mike Hawkins and Alexander Klemm, The Institute for Fiscal Studies, June 2004. The paper finds that if stamp duty is capitalised into share prices, it will depress prices more for shares that are more frequently traded. Their research indicates that the price of shares that are more frequently traded increases relatively to that of shares that are less frequently traded on announcement dates of cuts in stamp duty in 1984 (from 2% to 1%), in 1986 (from 1% to 0.5%) and 1990 (when it was announced that stamp duty would be abolished on shares with the introduction of the Taurus system – the Taurus system itself was eventually abandoned). However the question remains whether the negative effects of alternative sources of tax revenue would be smaller than those of stamp duty.

⁶⁷ London Stock Exchange/The Hundred Group of Finance Directors ‘Impact of Stamp Duty on Cost of Capital of UK Listed Companies’ July 2nd 2001, OXERA – page 10

Contracts For Difference

The continued existence of liability to stamp duty on transfers of UK shares has been given as one reason for the emergence of a more lucrative market in contracts for difference.

In his article, “‘UK Stamp Duty on Share Transactions,” Robert Lee⁶⁸ makes a point shared by other writers and practitioners too: *“As a result of the Chancellor’s decision not to abolish stamp duty on share transactions in his budget. Investors are already finding alternative ways of dealing which don’t attract stamp duty, for instance utilising derivative products such as Contracts for Difference (CFDs) and spread-betting systems. Such derivative products were not at first intended to be a replacement for share dealing, but were designed to compliment it, as devices to manage risk in sophisticated investment strategies. Now they increasingly seem to offer a realistic alternative to conventional trading.”*

A short browse through the internet shows many retail brokers offering CFDs and spread-betting. The advantages of those forms of trading are listed on their websites - “no stamp duty” is stated as a prime advantage.

Lee notes that:

“Figures published in January, 2005, confirmed the picture, showing that revenues from the United Kingdom’s stamp duty on share trades are likely to remain flat in 2005 at £2.6 billion, despite a sharp increase in the volume of shares traded on the London Stock Exchange. It seems the major reason for this is that investors are increasingly shunning traditional share purchases, which attract a transaction tax of 0.5% - a levy now almost unique in the industrialised world – in favour of derivatives known as contracts for difference (CFDs) which do not attract tax.”

The issues surrounding contracts for difference and stamp duty revenue collection are not unique to the UK. Most recently, the Irish Department of Finance issued a press release which makes it clear that there is a tension between revenue raising, trading in contracts for difference and a modern liquid market. The press release, released on 30 March 2006 reads as follows:

Cowen to review Stamp Duty on Share Transactions: Contracts for Difference

The Minister for Finance, Mr Brian Cowen, TD, today indicated that, in view of uncertainties and difficulties of which he had become aware, he plans to review the law as it relates to stamp duty on share transactions which underlie trading in Contracts for Difference based on Irish equities. The Minister said that he was anxious that the market in Irish equities would continue to be a modern, liquid market, conducive to capital acquisition by Irish firms. His Department would consult with the Revenue Commissioners and with market participants with a view to appropriate announcements being made in Budget 2007.

So what are contracts for difference? CFDs basically allow investors to profit on the movement of a share price without actually owning the physical stock. Essentially two parties enter an agreement to settle at the close of their contract, the difference between the opening and closing price of a company’s share price. Lee notes, *“firms that offer CFDs are able to hedge their exposure to the contracts by physically buying the underlying stock, and by doing*

⁶⁸ ‘UK Stamp Duty on Share transaction’ by Robert Lee, London. www.lowtax.net

so enjoy a tax concession that means they do not have to pay tax.” (The FISCO Group suspects that the tax concession alluded to here is Intermediary Relief.)

Marion Wrobel comments about UK stamp duty⁶⁹: *“Although the British stamp duty raised about £800 million per year, it did lead to a number of market responses designed to avoid the tax. Bearer securities grew at the expense of registered securities. To some extent, investors switched from equities trading to trading in equity derivatives that provided a similar return. Investors also increasingly used American Depository Receipts (ADRs) which allowed British active nominees to trade assets on American stock markets without incurring British registration duties.”*

The situation that results from both Lee and Wrobel’s observations may be described as market fragmentation. Effectively normal trading transactions that would have taken place in the London stock market have been diverted away from it.

The impact of market fragmentation on market liquidity is further explored by Amihud and Mendelson. They describe a market as fragmented when *“orders are decomposed into distinct subsets that do not fully interact, such as trading the same instrument in two independent markets.”*⁷⁰ They considered that:

“As a result, potential mutually-beneficial trades are missed and the quality of execution is inferior to that obtained in a consolidated market. Market fragmentation is costly. It reduces liquidity and increases overall trading costs, hampers price discovery and reduces the incentive to provide information to the market.”

In a 1982 study Cohen, Maier, Schwartz and Whitcomb looked at the effects of having, in addition to the main market, execution of orders in “satellite” markets managed by brokers off the exchange floor. They showed that while this is beneficial for the brokers, it harms the market as a whole. While some traders might do better for themselves in a fragmented environment, fragmentation reduces overall welfare because the fragmented market leads to a wider bid-ask spread and greater price uncertainty.⁷¹

Fragmentation also leads to inefficient price discovery. Mendelson (1982, 1985, 1987) studied the effects of the number of trades on the efficiency of the price discovery process. His research shows that there are important economies of scale in trading that facilitate both liquidity and efficient price discovery. The greater the number of traders in a single marketplace, the greater the likelihood that an incoming order to buy or sell will find a willing counterpart, that is, the greater the likelihood of execution at favourable terms. Volume begets volume in securities markets and this facilitates trading, increases liquidity and enables a quick incorporation of information into stock prices.⁷²

In summary, it has been argued that market fragmentation has been identified as a direct consequence of the continued existence of UK securities transaction taxes. There is evidence

⁶⁹ Financial Transactions Taxes: The International Experience and the Lessons For Canada, M G Wrobel, Senior Analyst, June 1996

⁷⁰ Effects of a new York State Stock Transaction Tax, Amihud and Mendelson, November 2003 (Partial financial support by the New York Stock Exchange is gratefully acknowledged). The comments and observations regarding market fragmentation are derived from this same paper.

⁷¹ That is to say, prices are less informative: the variance of the true value of the instrument is larger . The comments in this section are derived from: Effects of New York State Stock Transaction Tax... page 21

⁷² Effects of a New York State Stock Transaction Tax, Y Amihud and H Mendelson, November 2003

to show that fragmented markets affect liquidity and therefore, it can be said that transaction taxes affect market liquidity.

4.4.1.5. Spain

The Spanish Securities Market Act 24/1988 introduced an exemption from transfer and stamp duty taxes ("Impuesto sobre Transmisiones Patrimoniales y Actos Jurídicos Documentados") for share transactions. The sole purpose of the new law was explained in its preamble as follows:

"to strengthen our capital markets for the future, in 1992, European capital market and in response to the position previously taken by different European Union Member State in this issue. The final aim is our capital markets could be in proper conditions when that European Market comes to be a reality."⁷³

The idea was to prepare the Spanish Capital Market for the European Capital Market in 1992, by making it more efficient. Amongst the changes introduced in the Spanish law, article 108 of Act 24/1988 established an exemption for all kinds of transactions dealing in shares and other securities, both within and outside the Capital Market. Special situations were excluded from the exemption e.g. while transfers of shares of Spanish companies are generally exempt from any indirect taxation, this is not so where more than 50% of the capital stock of a company is transferred and at least 50% of the assets of the company consists of real estate located in Spain: in this case the transaction will be considered for indirect taxation purposes to be a transfer of real estate subject to Transfer Tax at 6%.

Thus, the purpose for introducing the exemption can be summarised as the need to modernise the Spanish Capital Market in preparation for Spain joining the European Community (1st January 1987).

The Law's preamble also explains that the introduction of the exemption is necessary in order to comply with what was the upcoming European Regulation on Indirect Taxation on Shares Exchanges - the exemption established in VAT has to be also applied in the Transfer and Stamp Duty Taxes.⁷⁴

In summary, the situation in Spain is that there is a General Tax for Transactions termed "Impuesto sobre Transmisiones Patrimoniales y Actos Jurídicos Documentados" which is not applicable to securities transactions (except in very few cases concerning operations with shares that are, in fact, global transmissions of companies or Real Estate Acquisitions) because of the existence of a specific exemption that was introduced in the 1988 Securities Market Act as a modernisation tool in the Spanish Capital Market.

⁷³ "potenciar nuestro mercado de valores ante la perspectiva, en 1992, de un mercado europeo de capitales y de una toma previa de posiciones a este respecto por diversos Estados miembros de la Comunidad Económica Europea. El objetivo final es que nuestro mercado de valores esté en condiciones apropiadas cuando dicho mercado europeo llegue a ser una realidad".

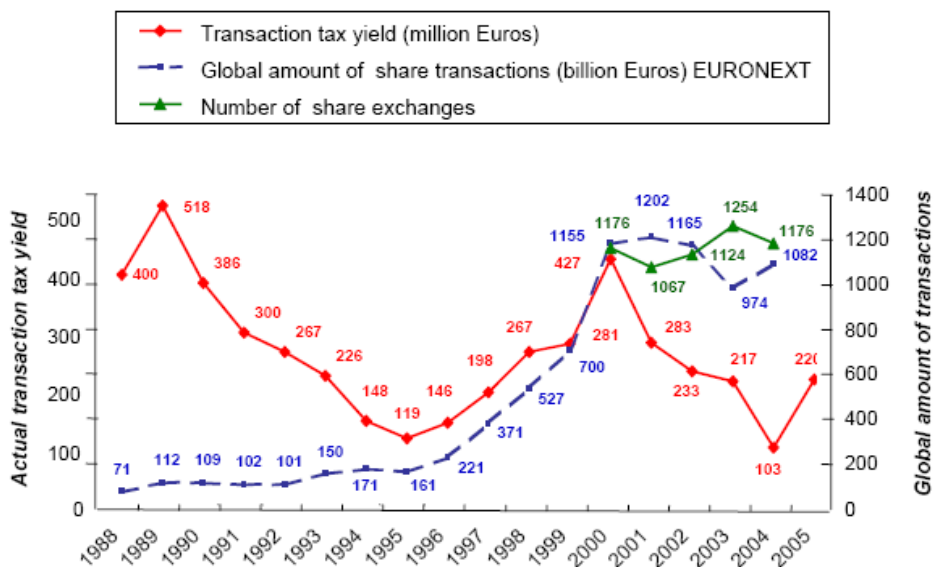
⁷⁴ "con objeto de atender la propuesta de Directiva de la Comunidad Económica relativa a los impuestos indirectos sobre las transacciones de valores, la exención prevista en el Impuesto sobre el Valor Añadido (VAT) se hace extensiva al Impuesto sobre Transmisiones Patrimoniales y Actos Jurídicos Documentados", i.e. the basis for extending the exemption to Spain's Transactional and Formal Documents Tax was the European Regulation on indirect taxation.

4.4.1.6. France

The information on France in section 3.2.1.2 of this fact-finding study includes the observation that, due to the method of collecting the tax, the French transfer tax ‘l’impôt de bourse.’ may have lead to an increased use of foreign brokers.

The FISCO Group understand that there is a general consensus amongst French financial professionals that there has in fact been a significant increase in the use of foreign intermediaries in the last five years.⁷⁵ The graph “Comparison of Transaction Tax Yield with Global Amount of Share Transactions in Paris” shows that since 2000, the transaction tax yield has fallen year-on-year to mid-2004, even though the volume and value of transactions has not fluctuated significantly.

Comparison of transaction tax yield with global amount of share transactions in Paris



4.4.1.7. Germany

Presently there are neither transaction taxes for securities transactions nor capital duty for the increase of shareholders capital in Germany. Formerly both types of taxes had existed, but they have been abolished as of 1991 (transaction tax) and 1992 (capital duty).

Transaction Tax

The German transaction tax (“Börsumsatzsteuer”) had its origin in the first stamp duty law that was issued in 1881. Thereafter the tax was based on the “Kapitalverkehrsteuergesetz” (Capital Transaction Tax Law) of the year 1922. This law has often been amended, the last time being at the end of 1985. The tax was finally abolished as of January 1991 by the “Finanzmarktförderungsgesetz” (Capital Markets Promotion Law). The official reasons for the abolition of the transaction tax have been:

- Capital transaction taxes are an impediment for the free movement of capital and are a disruptive factor for the economy.
- The elimination of distorted competition conditions within the capital markets in the European Community.
- In addition: simplification and harmonisation of tax rules according to the recommendations of the European Commission.

The decrease of the revenue has been estimated to about EUR 409 million in the first year of abolition. The decreases in the following years have not been estimated officially, but are presumably amounts to the same order.

Information about the effects of the tax abolition on the capital markets is not available. Apparently no research has been made. It seems that it was not possible in the years 1991ff. to carry out such special analysis, as would have been required. This is based on the particular situation in Germany at that time. The former Federal Republic of Germany had very recently started the unification with East Germany. In that phase there was a lot of optimism and euphoric ambience, especially in the German capital market. Additionally there were lots of new investors from the new German estates joining the existing capital market. Thus the capital market in Germany boomed. Under these circumstances there has been no reasonable chance to identify and separate the causations based on the tax abolition from the causations based on the political environment at that time.

The transaction tax was levied on the purchase price of a security as the basis of assessment. There have been three tax rates:

- 0.1 % on government bonds and similar securities,
- 0.2 % on investment fund units,
- 0.25 % on all other securities, such as shares and industrial bonds.

Capital duty

The German capital duty (“Gesellschaftsteuer”) had its origin in “deed taxes” that were levied for the first time in 1850. Thereafter the tax was based on the “Kapitalverkehrsteuergesetz” (Capital Transaction Tax Law) issued in the year 1922, together with the transaction tax discussed above. The tax was also abolished by the “Finanzmarktförderungsgesetz” (Capital Markets Promotion Law), however, for national budget purposes this took place one year after the transaction tax was abolished, i. e. January 1992. The official reasons for the abolition of capital duty have been:

- The capital duty is an impediment for equity capital formation.
- The taxation of capital raising goes against the aims relating to economic policy and wealth creation policy.
- In addition, simplification and harmonisation of tax rules according to the recommendations of the European Commission – same as transaction tax.

The decrease of the revenue has been estimated at about EUR 133 million in the first year of abolishment. The decreases in the following years have not been estimated officially, but are presumably amounts to the same order.

The capital duty was levied on the issue of shares by corporations. The tax rate was 1 % on the equity contribution.

4.4.2. Countries outside the EU

4.4.2.1. India

On 1 October 2004, the Securities Transaction Tax (STT) was introduced on the Indian financial markets. At the same time the capital gains tax payable on securities transactions was significantly reduced.⁷⁶

For the purchase and sale of equity shares settled by delivery through a recognized stock exchange, the STT is imposed at 0.075% on each leg of the transaction and is thus paid by both the seller and buyer. Where an equity sale transaction is settled through a stock exchange but not by delivery, the tax is levied on the seller only, at 0.015%.

It is the responsibility of the stock exchange to collect the tax at the correct rate on a monthly basis and pay it to Central Government by the 7th of the following month. The exchange also has to complete an annual return.⁷⁷

One of the main reasons for introducing this tax was to combat the highly speculative nature of the Indian financial markets by curbing purely short-term speculation by day traders or “noise traders.” K Singh⁷⁸ singles out the Indian markets as “amongst the most speculative markets in the world” and comments that more often than not this results in market manipulation by the big players. In brief Singh concludes that “STT would contribute towards restraining short-term trading thereby making Indian financial markets less volatile and more efficient.”

The comments and observations made in the months following implementation of the tax have been collated by Nayak and Shetty in their article “STT hits average daily turnover in Oct 2004.” The article notes that average daily turnover in October 2004 dipped to a 15-month low of INR 37,850 million (INR 37,850 million is approximately €680 million) on the National Stock Exchange. Nayak and Shetty also observe that apart from the daily average turnover, the daily average traded quantity of shares in October dipped to 236 million as against 285 million in September and 287 million in July 2004, the highest average daily traded quantity in FY 2004-05.⁷⁹

⁷⁶ The FISCO Group are very grateful to Ashish Gandhi (KPMG) for collating much of the information used in this section.

⁷⁷ Finance (No.2) Act 2004 , Sections 100 and 101.

⁷⁸ India Introduces Securities Transaction Tax, by Kavaljit Singh, 20 July 2004.

⁷⁹ STT Hits average daily turnover in Oct 2004, M Nayak and S Shetty, 16 November 2004, Financial Express.

The CEO of JM Mutual Fund, Kriahnamurthy Vijayan, said that *“following the introduction of STT, a lot of money from day traders and jobbers has started moving into the IPO market.”*

By contrast, K Singh comments, *“Going by the trading pattern in the equity markets, it is very clear that the STT had no significant negative impact.”*⁸⁰

An interesting remaining question is – did more long-term investors enter the market?

It can therefore be said that the introduction of the securities transaction tax affected market liquidity in terms of one of our measurements for market liquidity: i.e. volume of trades. The evidence supports an inverse relationship between liquidity and the existence of the tax. However, the real question is did the introduction affect the bid-ask spread of stock and if so, by how much? If the bid-ask spread of securities has narrowed since the introduction of the transaction tax in India, then is it possible to argue that the market has in fact become more liquid?

If the introduction of the transaction tax has removed the uninformed “noise traders” from the market place so that only informed, responsible traders are operating, then one might logically expect the difference between the price at which a seller is willing to sell and the price at which a buyer is willing to buy stock to be smaller i.e. moving towards convergence/price equilibrium. Of course there is the divergence caused by the additional costs of execution resulting from the introduction of the transaction tax. However, if the price movement towards a truer equilibrium is greater in size than the size of the divergence e.g. the amount of tax actually paid, then we may be in a position to say liquidity has improved.

This may be only a short-term, one-off, positive effect on liquidity.

The experience of India highlights that there is a subtle interplay between volatility and liquidity; price stability and volume fluctuation. That relationship is not explored here.

4.4.2.2. Japan

Japan’s economic boom period ended at the beginning of the 1990s, and this was visibly portrayed on the Japanese equities market by the fall in the Nikkei index from its peak of Y38, 917 in December 1989 to Y14, 309 in August 1992. The deficiencies of Japan’s securities markets led to low activity in domestic securities whilst at the same time there was a steady increase in offshore trading of Japanese stocks. Significant numbers of foreign companies de-listed from the Tokyo Stock Exchange (TSE) and more and more Asian companies were observed to be bypassing Tokyo in favour of listing in New York and other overseas markets.⁸¹

As a consequence, the Japanese government announced a dramatic reform of the financial systems which came to be known as the “Japanese Big Bang.” The overall aim, to make Japanese financial systems “free, fair and global,” is broken down by Reszat into four broad goals:

⁸⁰ India’s Transaction Tax Disproves All Fears, K Singh, 06 November 2004.

⁸¹ Japan’s Financial Markets: The Lost Decade – Beate Reszat, Hamburg Institute of International Economics, 2003.

- To increase investors' opportunities
- To improve the quality of financial services and promote competition
- To make markets more “user friendly” and
- To make trading fairer and more transparent

The decision to remove the securities transaction tax may be most closely aligned with the aim to increase investors' opportunities on the basis that transaction tax is an added cost for investors and thereby limits their opportunities to invest a finite pot of money.

In Japan, the transaction tax was formerly levied on the seller alone. The tax rate applicable depended upon the type of security and type of seller. Lower tax rates applied to licensed securities companies. Transactions in stocks were subject to a tax of 0.3% of the sale price for sellers that were not licensed securities companies and 0.12% for those with a license. Taxes were either collected by the securities companies and remitted to the government or were paid directly by the seller.⁸²

Empirical evidence shows that the number of listed companies on the Tokyo Stock Exchange increased dramatically in the post ‘Big Bang’ period. In 1999, the number of newly listed companies was more than 50% higher than the number of new listings in the previous year. In 2000, the number of new listings doubled compared with the 1999 figure, to 174 (this was the first time the number of newly listed companies reached triple figures in Japan)⁸³. There was also a steady increase in the number of individual investors on the market with individuals as a proportion of total investors increasing year-on-year between 1996 and 2001; the largest increase being in 2000⁸⁴.

The direct correlation between choice of venue for listing and liquidity has been shown both empirically and by academic analysis.⁸⁵

Overall, figures suggest that there has been an increase in liquidity in the Japanese stock markets after the abolition of transaction taxes. However, the extent to which the abolition of transaction tax, as against other measures introduced during the Big Bang, caused such a change in liquidity is unclear. Perhaps Japan is therefore an example of a market that was not harmed by the abolition of the tax, which in itself is valuable information for us.

4.5. CONCLUSIONS

- From the literature examined as well as the collective experience of the FISCO Experts, it is clear that there is general agreement that the existence of transaction taxes does affect market liquidity.
- However, the extent to which liquidity is affected is difficult to determine and controversial. One of the key difficulties is that of isolating the effect of transaction

⁸² IMF Working Paper, Securities Transaction Taxes and Financial Markets, K Habermeier and A Kirilenko (WP/01/51)

⁸³ Key Statistics for Listed Stocks – “Annual Securities Statistics 2002” Tokyo Stock Exchange

⁸⁴ Share Ownership in Listed Companies – The National Conference of Stock Exchange

⁸⁵ The Initial Listing Decisions of Firms that go Public – Corwin and Harris , page 8

taxes from all the other factors (including a particular country's political and historical context) which can influence market behaviour.

- The literature and observations from the different country experiences make it clear that liquidity is not the only attribute of a securities market to consider when looking at the effects of transaction taxes. Other important factors include controlling volatility and we have seen that transaction taxes play an important role here.
- Nevertheless, we have seen that a number of countries have had adverse experiences related to transaction taxes and their effects upon liquidity, share price fluctuation and transaction execution methods. As a result in some cases, governments have decided to abolish their local transaction taxes or to grant very wide exceptions.
- While the FISCO Group acknowledges that the revenue authorities may have their own views on the value of transaction taxes and in particular their revenue raising capability, the Group considers that in the light of the collective experiences described above, this is a matter which should be considered at EU level.

5. CONCLUSIONS

Community Law Background

- Any requirements concerning fiscal representatives in national tax legislation (whether explicit or implied) or withholding- and transaction tax-related procedures, will need to be closely scrutinised, with a view to examining their compatibility with the basic freedoms of the EC Treaty given the developing case-law of the European Court of Justice and the entry into force of the Recovery Directive (2001/44/EC).

Withholding Tax Procedures

- The country reports produced by the FISCO work demonstrates that withholding tax collection and relief procedures vary considerably among Member States and that different procedures often even apply to different classes of securities within the same Member State. In some cases, these variations reflect differences in the substantive withholding tax rules or particular concerns about tax evasion and avoidance. In most cases, however, different approaches are taken to the same practical problems without any specific reason and there is clearly room for rationalization as regards the fiscal compliance procedures.
- The complexity and administrative costs resulting from the above differences may lead investors to forego the relief to which they are entitled and may discourage cross-border investment for the same reason.
- In the view of the FISCO Group, the optimal withholding tax collection and relief procedures:
 - have sufficient audit and enforcement possibilities for local authorities to ensure the proper collection of withholding tax;
 - allow for the appropriate tax relief to be applied at source without excessive documentation requirements and without exposing issuers, intermediaries and investors to unnecessary risks and costs;
 - work in an equally efficient way, irrespective of the location in which securities are held or transactions settled (local versus foreign intermediary or CSD) and irrespective of the investment structure or settlement arrangements chosen by the investors and intermediaries (direct versus indirect access); and
 - ensure equal treatment of foreign and local intermediaries.
- None of the Member States have tax collection and relief procedures in place that meet all of the above criteria for all types of securities.
 - Several cases have been identified whereby procedural tax rules de facto prevent foreign intermediaries from obtaining direct access to the local CSD,

or at least do not allow them to obtain such access under similar conditions as local intermediaries;

- The procedural tax rules do not always take into account that securities transactions may settle outside in the books of a settlement service provider established outside the country of investment;
 - Although some Member States have taken initiatives to adapt their at source relief procedures to the environment in which securities are held through foreign intermediaries or have introduced rather efficient refund procedures for intermediaries it appears that very often withholding tax relief procedures are not adapted to an environment in which securities are held in omnibus accounts through multiple tiers of intermediaries.
- In some cases, the efficiencies that were identified apply equally to all involved parties. In some other cases, procedural tax rules put foreign intermediaries and/or investors at a disadvantage compared to local intermediaries and/or investors and may constitute a violation of the EC Treaty.

Transaction Tax Procedures

- Currently, eleven Member states have some form of a transaction tax on the transfer of securities.
- In most Member States, the responsibility to collect the transaction tax lies with the parties to the trade or their agent. Only in very few Member States is the responsibility to collect transaction taxes on securities transactions imposed on the settlement service providers.
- Tax rules that impose tax collection responsibilities on settlement service providers do not always take into account that securities transactions may settle in the books of several local or foreign settlement service providers and do not allow all such settlement service providers to collect transfer taxes under similar conditions. This issue may in the first place be important to the relevant tax authorities whose concern is lost revenues. However it may also put certain settlement service providers at a competitive disadvantage to others. These disadvantages may result from:
 - The legal uncertainty whether transactions settling in their books are subject to the transaction tax,
 - The absence of a legal framework for such settlement service providers to collect transaction taxes on transactions that take place in their books and pay and report this to the relevant tax authority.
 - The denial of exemptions of transaction taxes, if transactions linked to the one for which exemption is requested, are not settled by a settlement service provider with tax collection responsibilities.

Transaction taxes and Market Liquidity

- From the literature examined as well as the collective experience of the FISCO Experts, it is clear that there is general agreement that the existence of transaction taxes does affect market liquidity.
- However, the extent to which liquidity is affected is difficult to determine and controversial. One of the key difficulties is that of isolating the effect of transaction taxes from all the other factors (including a particular country's political and historical context) which can influence market behaviour.
- The literature and observations from the different country experiences make it clear that liquidity is not the only attribute of a securities market to consider when looking at the effects of transaction taxes. Other important factors include controlling volatility and we have seen that transaction taxes play an important role here.
- Nevertheless, we have seen that a number of countries have had adverse experiences related to transaction taxes and their effects upon liquidity, share price fluctuation and transaction execution methods. As a result in some cases, governments have decided to abolish their local transaction taxes or to grant very wide exceptions.
- While the FISCO Group acknowledges that the revenue authorities may have their own views on the value of transaction taxes and in particular their revenue raising capability, the Group considers that in the light of the collective experiences described above, this is a matter which should be considered at EU level.

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ANNEX II. MANDATE FOR THE EU CLEARING AND SETTLEMENT FISCAL COMPLIANCE EXPERTS' WORKING GROUP.



EUROPEAN COMMISSION

Internal Market and Services DG

On 28 April 2004 the Commission adopted a Communication entitled “Clearing and Settlement in the European Union – The way forward” (ref: COM(2004) 312 final). This paper sets out broad policy guidelines for further Community action in the field of securities clearing and settlement and elaborates on the necessary means to achieve an integrated, efficient and safe clearing and settlement environment in the European Union.

The integration of existing structures in the EU will require, among other actions, coordination between private and public sector bodies in bringing down a great diversity of barriers to cross-border securities clearing and settlement. This will be a complex and difficult process requiring not only technical expertise but also the wide support of the business community and of political leaders. The Commission considered in its Communication that the best way to ensure both technical expertise and political support would be to create three working groups made up of external experts, each the Commission chairing. These are a more general and political “Clearing and Settlement Advisory and Monitoring Group” and two more specialised and focused groups which are to address the legal and tax barriers to cross-border clearing and settlement.

The relevance of barriers to efficient cross-border Settlement was also one issue contained in the subsequent consultation to the First and Second Commission Communication on Clearing and Settlement. Indeed, some respondents considered that, while substantive tax harmonisation is not currently necessary, harmonisation of the different procedures involved in tax processing should be pursued, while at the same time ensuring equal treatment for domestic and foreign investors.

The Giovannini Reports identified and invited public authorities to tackle a number of practical problems that arise from the procedures whereby only certain intermediaries are permitted to apply a reduction of the normal rate of withholding tax. In particular, some Member States only permit institutions established within their territory to operate withholding tax procedures. Other Member States allow foreign intermediaries to apply reduced rates of withholding tax but only on condition that they appoint a local fiscal representative. The Giovannini Reports suggest that such a situation effectively prevents the possibility for an intermediary to operate on a cross-border basis or to use the Intermediary services of a Securities Settlement System, thus greatly limiting competition in the provision of cross-border Settlement services. Therefore, market participants are prevented from choosing the most efficient way to operate cross-border, which in turn increases the inefficiency of the whole process.

Moreover, differences exist in the procedures used in the various Member States to collect, or grant relief from, withholding tax. Even if total or partial relief is granted, eligible investors may be required first to suffer the tax and subsequently reclaim it. Procedures applicable to repayment of withholding tax can be very complex and may also differ considerably across Member States. Such complexities and differences significantly increase the cost of cross-border Settlement.

The Giovannini group also suggested that the integration of the system for collection of transaction taxes, within the functionality of existing Securities Settlement Systems in the EU, constituted a further tax barrier. In such circumstances, the Reports suggested that using a different Securities Settlement System could mean paying higher transaction taxes. Should that prove to be the case, other Securities Settlement Systems may be *de facto* prevented from offering Intermediary services in cross-border Settlement, thus reducing the efficiency of the system. The Giovannini group of experts invited public authorities to consider this barrier and to propose appropriate solutions.

The Commission notes that there is an increasing tendency to move away from withholding taxes towards a greater reliance on information exchange. This enables tax authorities to have the proper information available to them in order to charge the right amount of tax on the right person. Information exchange on as wide a basis as possible underpins Council Directive 2003/48/EC dealing with taxation of income in the form of interest received across national frontiers⁸⁶. Moreover, there is now a Directive for Mutual Assistance on Recovery⁸⁷, under which the competent authorities of one Member State can assist those of another with the collection of both direct and indirect taxes due in the first-mentioned state from a debtor located in the second. In addition, the original Directive on Mutual Assistance⁸⁸ is currently undergoing modernisation with a view to strengthening it. Therefore, Member States will have better possibilities for controlling taxpayers who are located outside their territorial jurisdiction.

Given this new context, it is an opportune moment to explore the additional possibilities that are now available to see whether changes in some of the existing rules might be introduced in order to simplify matters for business, while still safeguarding the rights of Member States in relation to tax collection.

Consequently, the Commission has proposed the creation of a Fiscal Compliance Experts' group. The Commission is aiming to ensure the participation of high level representatives of various (possibly private legal and tax and public/academic sector) bodies involved and knowledgeable in the cross-border taxation issues related to the process of clearing and settlement of securities (e.g. withholding tax, transaction taxes, tax on capital gains). Members of the Experts' Working Group should preferably also be able to easily retrieve information about more than one Member State of the EU.

The Experts' Working Group will be chaired by the Commission and conduct its work as openly as possible (e.g. by establishing transparency through its website). Overall, the Group

⁸⁶ Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments, OJ 2003 L175/38

⁸⁷ Council Directive 2001/44/EC of 15 June 2001 amending Directive 76/308/EEC on mutual assistance for the recovery of claims resulting from operations forming part of the system of financing the European Agricultural Guidance and Guarantee Fund, and of agricultural levies and customs duties and in respect of value added tax and certain excise duties, OJ 2001 L175/17

⁸⁸ Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, OJ 1977 L336/15

shall endeavour to proceed in conformity with the themes of the Commission's work relating to EU clearing and settlement, ensuring wide dissemination to the public of all necessary information, explanations and reports on the state of progress, building awareness of the relevance of the project for the success of the EU's financial markets and for the attainment of the objectives incorporated in the Lisbon agenda. The work may last for about two years.

The tasks of the group are:

(14) To examine the fiscal compliance issues identified by the Giovannini group and by respondents to the First and Second Commission Communication on Clearing and Settlement as constituting barriers to efficient cross-border Settlement. The expert group should further consider and analyse such issues, with a view to reporting on their relevance and on whether alternative ways might be found for Member States to secure their tax receipts, while still permitting all financial institutions across the European Union to compete on an equal footing.

(15) The remit of the expert group would also include the undertaking of a Study of the different fiscal compliance procedures in place across Member States, with a view to seeing whether these might be capable of being more closely aligned, so that the existence of a multiplicity of rules, which, among other things, raise the cost of cross-border Settlement, could be eliminated or substantially reduced.

(16) To identify other fiscal compliance related issues.

(17) Liaise with the other groups mentioned in the Communication on Clearing and Settlement, being CESAME and the Legal Certainty Group (which are reciprocal relationships).

The Commission will consider the findings of the expert group and will use them as a basis for discussion with the Member States and in accordance with the established policy of prior consultation on tax issues. If subsequent action at a Community level is considered appropriate, the Commission will endeavour to bring forward appropriate proposals.

ANNEX III. GIOVANNINI REPORT; FISCAL COMPLIANCE BARRIERS 11&12.

Removing Barrier 11

All financial intermediaries established within the EU should be allowed to offer withholding agent services in all of the Member States so as to ensure a level playing field between local and foreign intermediaries. Removing this barrier is the responsibility of national governments and could be coordinated via the relevant EU Council. This barrier should be removed within a period of three months of removing Barriers 7 and 1.

Barrier 11 relates to domestic withholding tax regulations. The majority of Member States restricts withholding responsibilities to entities established within their own jurisdiction. In consequence, foreign intermediaries are disadvantaged in their capacity to offer at source relief from withholding tax by the significant extra cost of using a local agent or local representative in the discharge of their withholding obligations. The Group recommends that national governments should take immediate steps to allow foreign intermediaries to act as withholding agents in all of the EU Member States. National governments should co-operate closely with the private sector in implementing this recommendation. Such co-operation would seem particularly appropriate in light of the G 30 proposal to establish an international group on taxation issues, which would also comprise representatives of the public and private sectors. Removal of this barrier should be achieved within three months of removing Barriers 7 and 1.

Removing Barrier 12

Any provisions requiring that taxes on securities transactions be collected via local systems should be removed to ensure a level playing field between domestic and foreign investors. This is clearly a responsibility of national governments and their actions should be coordinated via the relevant EU Council. This barrier is to be removed within a period of three months of removing Barriers 7 and 1.

Barrier 12 relates to the collection of transaction taxes through a functionality that is integrated into a local settlement system. In these circumstances, the foreign investor's choice of provider for securities settlement is reduced because it is necessary to link up with the local settlement system that operates the tax collection functionality. To ensure a level playing field between domestic and foreign investors, the Group recommends that any provisions requiring that taxes on securities transactions be collected via local systems should be removed. This is clearly a responsibility of national governments and consistency in the removal of these restrictions could best be guaranteed by coordinated action via the relevant EU Council. As with Barrier 11, national governments should co-operate closely with the private sector in implementing this recommendation. Removal of this barrier should be achieved within three months of removing Barriers 7 and 1.

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