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The French Financial Transaction Tax: A Sign of Things to Come?

In anticipation of the implementation of the draft directive published by the EU Commission on 28 September 2011 for a tax on financial transactions, on 8 February 2012 the French government submitted for parliamentary approval proposed legislation to introduce a unilateral financial transaction tax ("French FTT") in France. The French FTT is included in the Amended Finance Law for 2012 of 14 March 2012 adopted by the French Assemblée Nationale and will come into effect on 1 August 2012. The new tax is projected to raise EUR 1.1 billion per year.

Though narrower in scope than its proposed EU counterpart, the French FTT is likely to have an impact not only in France but also globally.

How the French FTT Works

The French FTT is not a single tax, but is composed of three separate taxes. The first element (and the element which seems likely to have the widest impact) is a 0.1% tax on the acquisition of "equity instruments" of French companies:

(a) with a registered office in France;

(b) with a market capitalisation of over EUR 1 billion; and

(c) whose shares are listed.

For these purposes "equity instruments" is widely defined to include shares and other equity instruments which give or can give access to capital or voting rights (but not bonds even if such bonds are convertible into or exchangeable for shares or carry a coupon linked to the profits of the issuer). Exemptions are available for activities such as those carried out by clearing houses or depositary receipt systems, market-making activities and intra-group transactions. There is also an exemption for the primary issue of equity instruments and temporary transfers of securities such as stock loans and repos. The tax will be due on the first day of the calendar month after that in which the acquisition of the relevant equity instruments takes place and will be payable by the financial intermediary that executed the purchase order or negotiated the purchase order for its own account, regardless of where the relevant financial intermediary is located. In the event that a particular transaction does not involve a financial intermediary, the tax would instead be due from the relevant custodian. It is worth noting that from 1 August 2012 transfers of the listed shares of French companies with a market capitalisation of less than EUR 1 billion (and which would therefore fall outside the French FTT regime) will instead be subject to 0.1% transfer tax if a transfer deed is executed (currently, the rates of the French transfer tax range from 0.25% to 3%).

The second element of the French FTT is a tax on certain credit default swaps ("**CDS**") on sovereign bonds purchased by individuals domiciled in France, companies incorporated in France and French establishments of non-French companies. This tax is levied at the rate of 0.01% on the notional value of the CDS. However, it only applies to "bare" CDSs, where the beneficiary of the CDS does not hold a corresponding long position on the related sovereign bonds (or an asset/instrument the value of which is linked to such bonds). Market makers are exempt from this tax on bare CDSs; however, none of the other exemptions which are available for the "equity investment" tax are available for the CDS tax.

The third element of the French FTT is a 0.01% tax on high frequency trading ("**HFT**"). The tax applies to a French company, or the French branch of a non-French company, engaging in HFT for its own account. HFT is defined as the use of an automated system to transmit, change or cancel a series of orders for a given security, with these orders separated by a time period that has yet to be determined, but in any case will not exceed one second. As soon as the company modifies or cancels a certain percentage of orders within a trading day, the tax is triggered, and applies to the value of the cancelled or modified transactions that exceed the threshold. The exact threshold at which the tax will be triggered is yet to be decided, but it will not be less than two-thirds of the daily orders.

Rationale Behind the French FTT

Ostensibly, both the (some might say, somewhat simplistic) belief that financial transactions are exempt from taxation and current sentiment across Europe have encouraged France to look to the financial sector to contribute further to public finances. With the primary aim of the tax on equity instrument transfers seemingly revenue raising, the proposal is couched in terms of producing a tax yield and minimising the risk of driving away financial activity. This can be contrasted with the taxes on CDS and HFT activities which would appear to be directed at discouraging transactions that the French government regards as speculative in nature.

The Impact

It was noted in the proposal for the French FTT that there may be a decrease in trading volume of the affected instruments, which could lead to less revenue for Euronext and multilateral trading systems (most of which are established outside France) that capture a portion of the flow of orders on French securities. There is also likely to be a negative impact on the price of securities within the "equity investments" definition, though this is unlikely to be as large as the 10% drop predicted by analysts with regard to the EU proposal, as the French proposal includes an exception for market making (which would prevent a cascade of cumulative tax charges inherent in the current form of the EU proposal). In general, the French government seems confident that the French FTT will not have a materially negative impact, and that the low rate of tax, in conjunction with the complexity and costs associated with changing a company's registered office, mean that the risk of flight of taxed activities is limited. This may well be the case, although there have been some suggestions that in some cases the tax, together with other tax measures announced by the candidates to the French Presidency, may in fact lead French groups reconsidering the location of their headquarters.

As discussed above, bare sovereign CDS trading and HFT appear to be regarded by the French government as particularly speculative activities that do not contribute stability or useful liquidity to the market. It is argued that a decrease in these transactions will help make the operation of the market more transparent for long term investors and regulators, which in turn reinforces stability. Thus, it seems that the tax on these activities is actually aimed at discouraging their use.

The French FTT and the Proposed EU Financial Transaction Tax

Although the provenance of the French FTT is very much rooted in the proposed EU tax on financial transactions, and the French government has stated its anticipation and support for an EU directive, the two differ significantly. Many of these differences stem from the unilateral nature of the French proposal. For example, corporate and sovereign bonds are excluded from the French FTT, as the French government believes that to do otherwise may impact France's long term financing in relation to other EU member states. A possible consequence of France unilaterally introducing a financial transactions tax is the risk of driving financial activities out of France to competing countries. Therefore, derivatives in general are not included in the French FTT as the derivatives market is particularly competitive, so that a tax on this sector could lead to a rapid flight of the exchange of listed derivatives. In relation to the tax on equity instruments, the risk of evasion also led to the French FTT not using the EU principle of territoriality based on the residence of the parties to determine whether a transaction is in scope, but instead looking at the status of the issuing company. In this way, the "equity instrument" element of the French FTT bears more similarity to UK stamp duty than the EU draft; a fact that the French Finance Minister, François Baroin, has used to defend the French FTT from criticism that France is "going it alone". Another significant difference between the French FTT and the EU proposal is the presence of several important exemptions from the French FTT, such as for market-making activities, intra-group transfers and hedging in the context of CDSs. The absence of such exemptions in the EU proposal has been heavily criticised, and so the French FTT may indicate a potential path forward on this front.

It will be interesting to see whether the EU follows the French lead in abandoning the territoriality principle in favour of a "stamp duty" covering securities issued by entities within the territories covered by the EU FTT.

A Sign of Things to Come?

While the French FTT may not immediately alter the financial landscape, it is clear that the French government considers the French FTT a preliminary step towards an EU-wide financial transaction tax. At present, though, it seems likely that the required unanimity of member states for an EU tax directive will present a significant stumbling block. The United Kingdom remains opposed to such a tax and it may be that other EU member states (for example, Ireland) would also object to its introduction or to any form of tax harmonisation. EU finance ministers have arranged to discuss the Commission's proposal at the end of March and to explore 'possible alternative routes' forward.

With these political complications still yet to be resolved, it seems likely that, for now, the French FTT may serve more as a blueprint for those EU member states which are prepared to "go it alone" in the future. In this way, even if an FTT is not introduced across the EU, the form that the French FTT has taken, how wide an impact it has and how successful it is in achieving its objectives may be an interesting taste of things to come.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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