

TECHNICAL FICHE¹

THE "RESIDENCE PRINCIPLE" AND THE TERRITORIALITY OF THE TAX

The residence principle as defined in Article 3 is one of the crucial components of the proposal for an FTT with the aim to reduce to an acceptable level the risk of tax avoidance through geographical relocation of transactions outside the EU. Indeed, taking that financial companies are less mobile than financial transactions, taxing institutions that carry trade on the basis of the residence principle mitigates these geographical relocation risks compared to taxing transactions at source or at the place of issuance.

This principle as defined in Article 3.1 (a) to (d) of the proposed directive allows for the trading activities of financial institutions resident in the EU to be taxed, even if such transactions are carried out in third countries' jurisdictions:

Article 3.1:

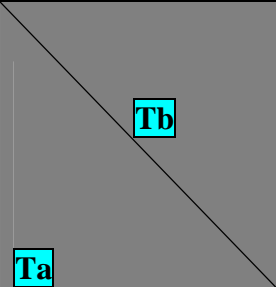


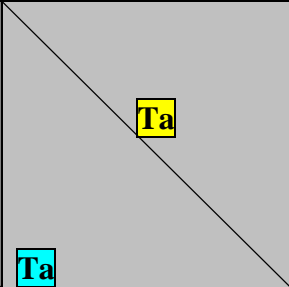


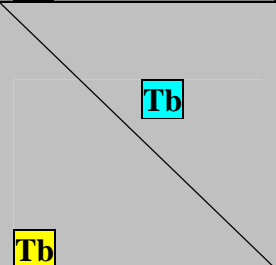


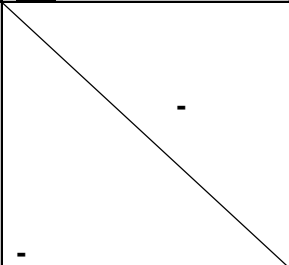

"For the purposes of this Directive, a financial institution shall be deemed to be established in the territory of a Member State where any of the following conditions is fulfilled:

- (a) it has been authorised by the authorities of that Member State to act as such, in respect of transactions covered by that authorisation;*
- (b) it has its registered seat within that Member State;*
- (c) its permanent address or usual residence is located in that Member State;*
- (d) it has a branch within that Member State, in respect of transactions carried out by that branch;*
- (e) it is party, acting either for its own account or for the account of another person, or is acting in the name of a party to the transaction, to a financial transaction with another financial institution established in that Member State pursuant to points (a), (b), (c) or (d), or with a party established in the territory of that Member State and which is not a financial institution."*





According to this approach, it does not matter where a transaction is carried out but who the transaction partners are. Also, most financial institutions trading in the EU typically need to be authorised and are – in application of Article 3.1 (a) – deemed to be established in the EU.

¹ This technical fiche should be considered as a non-paper that commits only the Commission's services involved in its preparation.

The residence principle can be summarised as follows:

Party/ counterparty	EU financial institution (Member State B)	Non EU financial institution
EU financial institution (Member State A)	  	  
Non EU financial institution	  	 - 

Legend:

: tax of country A; : tax of country B; Tax paid by  EU Party; Tax paid by  Non EU party

The taxation rules also apply when an FI is not a direct party but is acting on behalf of a party to the transaction. Where an FI acts in the name or on account of another FI only that other FI shall be liable to pay the tax.

In order to prevent the circumvention of the tax, in essence this rule has been extended to cover those cases in which a EU party (be it financial or non-financial) is trading with a financial counterparty established outside the EU, as described in Article 3.1 (e) of the proposal (see example 2 in the box below). This provision took its inspiration from the VAT directive (Article 58 of Directive 2006/112/EC). The FTT due would then accrue to the Member State in which the European financial institution is deemed to be established (see the two lightly-shaded cells in the above matrix). The only possibility for EU resident entities to avoid the proposed tax is to relocate themselves to third countries completely or through the formation of subsidiaries and in both cases give up their European customer base, a strategy which it is unlikely to be adopted.

The territoriality of the tax (Art. 3.1)

Example 1:

A bank established in Germany carries out a financial transaction with an insurance undertaking established in Spain, e.g. the sale/purchase of shares.

- FTT is due both in Germany and Spain, respectively (Art. 3.1), at national rates.
- If the market price of the transaction was EUR 600.000, and both countries applied the minimum rate of 0.1%, each financial institution would have to pay EUR 600 FTT.

Example 2:

A hedge fund established in France enters into a swap agreement with a bank established in Switzerland.

- FTT is due twice in France at national rate, by the Swiss bank deemed to be established in France (Art. 3.1.e) and by the French bank.
- If the notional value of the swap was EUR 600.000, and France applied the minimum rate of 0.01%, each financial institution would have to pay EUR 60 FTT.

In order to avoid extra-territoriality of the proposed FTT provisions it is also foreseen (see Article 3.3) that a financial institution shall not be considered established in the territory of a Member State *"in case the person liable for payment of FTT proves that there is no link between the economic substance of the transaction and the territory of any Member State."*

The below box illustrates how this provision could be applied.

Economic substance (Art. 3.3)

Example 1:

A Chinese bank and a Chinese investment firm, who acts in the name of a Chinese branch of an industrial company established in Germany, conclude a currency futures contract in China for operations of the industrial company in Germany.

- EU FTT is due at the German rate as both the Chinese bank and the Chinese investment firm are deemed to be established in Germany (Art. 3.1.e).
- If the notional value of the agreement at the time of conclusion of the future contract was EUR 600.000, and Germany applied the minimum rate of 0.01%, both the Chinese bank and the Chinese investment firm would have to pay EUR 60 FTT.

Example 2:

Same case as the first example, but this time it is a commodities (such as steel) futures contract for operations of the German company in China:

In principle, FTT is due as both the Chinese Bank and the Chinese investment firm are deemed to be established in Germany (Art. 3.1.e), unless both Chinese companies can prove that there is no link between the economic substance of the transaction and the territory of Germany (Art. 3.3). Such proof is not available, however, where the operations of the German company in China have an impact on the balance sheet of the German headquarter.

In the debate, some advocated adding the issuance principle to the residence principle as defined in the proposal to better minimise the risks coming from possible avoidance schemes. This approach would allow to tax trading in at least some financial instruments issued in the EU even when Article 3.1.a to 3.1.e do not apply. Where applicable, it would also make taxable cases where two non-EU financial institutions were party to a transaction or were acting in the name of exclusively non-EU parties to the transaction on certain instruments issued in the EU, thus transactions where there was no EU party involved at all. This approach would take its inspiration from the UK Stamp Duty and Stamp Duty Reserve Tax which is solely based on the issuance principle. Taking into account its possible positive impact on fighting tax avoidance, in case the requirement that at least one party to the transaction must be established in a Member States is not fulfilled, this issue might deserve further technical examination.