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The Financial Transaction Tax Proposal Under the Enhanced Cooperation Procedure: Legal and Practical Considerations

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This article examines the European Commission's Proposal for a Council Directive implementing a financial transaction tax through the enhanced cooperation procedure published on February 14, 2013. It starts by providing a brief description and analysis of the Proposal and the accompanying Impact Assessment, focusing on the newly added features of the proposed tax and its potential impact on both participating and non-participating Member States. Next, the article examines the Proposal from the perspective of public international law, discussing the controversial extraterritorial reach of the proposed tax. It is argued that doubts exist with respect to the compatibility of the "contagion effect" and the issuance principle with internationally recognised legal principles. The article then turns to EU law and considers the legal requirements imposed by the EU Treaties on the use of enhanced cooperation. Whilst raising some concerns in relation to the Proposal's compliance with these requirements, the article concludes that the political and judicial controlling mechanisms in place appear weak and therefore the outcome of any potential political or judicial challenge remains uncertain. The importance of this debate is not limited to the financial transaction tax, but also extends to the use of enhanced cooperation in other areas of taxation and beyond.

I. Introduction

On February 14, 2013 the European Commission (the Commission) published its proposal for a Council Directive implementing a financial transaction tax through the enhanced cooperation procedure (the Proposal).[1] This development constitutes another significant chapter in the financial transaction tax (FTT) saga, and brings the introduction of this controversial tax a step closer. The Commission's original proposal for the adoption of an FTT by all 27 Member States published in September 2011 (the 2011 Proposal)[2] sparked intense debate and proved to be deeply divisive. Despite the Commission's efforts, the differences in opinion amongst Member States could not

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[1] Commission Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final of February 14, 2013.

[2] Commission Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC, COM(2011) 594 final of October 28, 2011.

be bridged, as was finally confirmed in the Council meetings held in June and July 2012. In October 2012, 11 Member States in favour of the FTT requested the Commission to use a "last resort" option envisaged by the EU Treaties: the enhanced cooperation procedure (ECP). This allows a sub-group of Member States, subject to the fulfilment of some conditions, to introduce measures that only bind the participating Member States. The Commission considered that the required conditions were met and the Council then authorised the use of the ECP in January 2013, allowing Austria, Belgium, France, Estonia, Italy, Germany, Greece, Portugal, Slovakia, Slovenia and Spain to proceed.

The strengths and weaknesses of FTTs in general, and the Commission's 2011 Proposal in particular, have been debated at length.[3] These discussions are not repeated here. Instead, the focus is on the new questions raised by the Proposal.

This article proceeds as follows. Section II presents a brief description and examination of the Proposal and the accompanying Impact Assessment (IA).[4] It provides an update on the design of the proposed tax and the Commission's analysis in support of it, thus laying down the foundations for the discussion in the sections that follow. Section III examines the Proposal from the perspective of public international law. One of the most controversial elements of the FTT proposed in 2011 was its wide extraterritorial reach. This has been extended even further in the Proposal through the introduction of the "issuance principle". This section thus considers the compatibility of the connecting factors employed in the Proposal with the principles established by international law. Section IV analyses the Proposal in light of EU law. In particular, it discusses the procedural and substantive requirements imposed by the EU Treaties on the application of the ECP, the suitability of this integration model for introducing the FTT and the controlling mechanisms put in place. Section V concludes.

II. The new Proposal and Impact Assessment

1. The Proposal

(a) The proposed FTT in outline

In their formal requests to the Commission, the 11 participating Member States indicated that the tax should be based on the Commission's 2011 Proposal. The new Proposal thus maintained a wide scope, both in terms of the financial transactions upon which it is levied and the financial institutions subject to it, and an extensive territorial reach.[5]

[3] One of the present authors published a note in this review which was critical of the 2011 Proposal. See J. Vella, C. Fuest and T. Schmidt-Eisenlohr, "The EU Commission's Proposal for a Financial Transaction Tax" [2011] BTR 607.
[4] Commission Staff Working Document, "Impact Assessment accompanying the document Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax: analysis of policy options and impacts", SWD(2013) 28 final of February 14, 2013 (IA). Although this document is entitled "Impact Assessment", the Commission acknowledged that it "does not constitute in itself an Impact Assessment". This is because it should be read together with the impact assessment accompanying the 2011 Proposal and the further analysis produced by the Commission.
[5] For an overview of the Proposal and the issues it raises see Clifford Chance, "The European Commission's financial transaction tax proposal—what it means for investors and institutions in Europe and worldwide" Briefing Note, February 14, 2013, available at: *http://www.cliffordchance.com/publicationviews/publications/2013/02/the_european_commissionsfinancialtransactio.html* [Accessed March 26, 2013].

The tax is levied on a broad range of "financial transactions" including the purchase, sale and exchange of "financial instruments",[6] intra-group transfers of financial instruments, the conclusion of derivatives contracts, repurchase agreements (repos), reverse repurchase agreements (reverse repos), and securities, lending and borrowing agreements.[7] Transactions are caught whether they are carried out in an organised market or over the counter (OTC), however, a number of exemptions apply, including transactions on primary markets for securities and currencies.[8]

For the tax to apply, one party to the transaction must be a "financial institution",[9] a term encompassing a range of entities.[10] Also, one party, whether or not the financial institution, must be "established" in a participating Member State.[11] The concept of establishment is unexpectedly far-reaching, as further discussed in Section III. The tax is payable by each financial institution involved in the transaction to the participating Member State in which it is deemed to be established,[12] at the rates set by the participating Member State. The Proposal merely lays down the minimum rates for the tax at 0.01 per cent of nominal value for derivatives and 0.1 per cent for all other financial transactions.[13]

(b) Main changes found in the Proposal

The main changes found in the Proposal include: the treatment of repos, reverse repos, and securities, lending and borrowing agreements as single transactions[14]; the exemption of the primary issuance of shares and units in Undertakings for Collective Investments in Transferable Securities (UCITs) and alternative investment funds[15]; the exemption of financial transactions undertaken in the context of a restructuring covered by Article 4 of the Capital Duty Directive[16]; and the exclusion of managers of public debt of Member States from the scope of the tax.[17] Some of these changes will have a considerable impact. The authors, however, will focus on what are arguably the most interesting novelties, namely those addressing avoidance.[18]

[6] The term "financial instruments" covers a broad range of instruments, including, equities, bonds, units in collective investment undertakings, derivatives (options, futures, forwards, swaps, etc.) and structured products. Proposal, above fn.1, Art.2(3).

[7] Proposal, above fn.1, Art.2(1)(2).

[8] Proposal, above fn.1, Art.3(4)(a), other transactions are exempt under Art.3(4)(b)–(g).

[9] Proposal, above fn.1, Art.3(1), certain entities, however, are excluded under Art.3(2).

[10] The term "financial institution" includes, amongst others, credit institutions, pension funds, insurers, investment firms, undertakings for collective investments in transferable securities (UCITS) and alternative investment funds, Proposal, above fn.1, Art.2(8). A "financial institution" is deemed to be a party to a transaction if it is acting for its own account, for the account of other persons, or in the name of a party to the transaction, Proposal, above fn.1, Art.3(1).

[11] Proposal, above fn.1, Art.3(1) and Art.4.

[12] Whether the financial institution (a) is party to the transaction, acting either for its own account or for the account of another person; (b) is acting in the name of a party to the transaction; or (c) the transaction has been carried out on its account. Where a financial institution acts in the name or for the account of another financial institution only the latter financial institution shall be liable to pay. Proposal, above fn.1, Art.10(1)–(2).

[13] Proposal, above fn.1, Art.9.

[14] Proposal, above fn.1, Art.2(2).

[15] Proposal, above fn.1, Art.3(4)(a).

[16] Council Directive 2008/7/EC of February 12, 2008 concerning indirect taxes on the raising of capital [2008] OJ L46/11.

[17] Proposal, above fn.1, Art.3(2)(c).

[18] The term "avoidance" is here used in a broad sense. It includes transactions ranging from legitimate tax planning which complies with the law to aggressive tax planning which does not comply with the law.

One of the main criticisms of FTTs in general is their susceptibility to avoidance, primarily through instrument substitution and activity or entity relocation. The 2011 Proposal addressed the former by bringing a wide range of financial transactions within the ambit of the tax and the latter through the tax's considerable geographical reach. Despite the Commission's continuing faith in the 2011 Proposal's "broad base and powerful anti-relocation, anti-evasion and anti-avoidance features",[19] the participating Member States clearly retained concerns in this respect. In fact, the only instruction given to the Commission in preparing the Proposal, apart from following the 2011 Proposal, was to ensure that "evasive actions, distortions and transfers to other jurisdictions are to be avoided."[20] The Commission responded by introducing a number of changes aimed at improving the robustness of the tax.

(i) **Rules closing specific avoidance opportunities.**

Several changes have been introduced to close off specific avoidance opportunities. For instance, "for reasons of avoiding tax circumvention" an exchange of financial instruments is deemed to give rise to two financial transactions.[21] Under the 2011 Proposal, modifications of derivatives agreements were considered to be taxable transactions[22] but modifications of other financial instruments were not, allowing considerable scope for avoidance opportunities. The Proposal thus extends the tax to the modification of all financial instruments, on condition that it is material.[23] It also introduces a targeted anti-avoidance rule against the "abusive" use of depositary receipts and similar securities.[24]

(ii) **General Anti-Abuse Rule.**

Given the limitations of stopping abuse through targeted rules, the Proposal also introduces a General Anti-Abuse Rule (GAAR), which is based on the GAAR included in the Commission Recommendation of December 6, 2012 on aggressive tax planning.[25] This GAAR appears to be broader than those found in previous Directives[26] and merits careful study in its own right. The authors will limit themselves to five brief points.

First, on an initial reading of the GAAR one is struck by the multiple concepts it employs. It reads like a roll call of every concept used in anti-avoidance provisions and jurisprudence: artificiality, arrangements the essential purpose of which is to avoid tax, economic substance, commercial substance, reasonable business conduct, self-cancelling transactions, circularity and the object/spirit/purpose of the law. It is not clear that the use of multiple concepts enhances the robustness of a GAAR.

[19] IA, above fn.4, 50. See also IA, above fn.4, 4 and 9.
[20] IA, above fn.4, 9.
[21] Proposal, above fn.1, 8 and Art.2(2).
[22] 2011 Proposal, above fn.2, Art.2(1)(1).
[23] Proposal, above fn.1, Art 2(2).
[24] Proposal, above fn.1, Art.14.
[25] Commission Recommendation on aggressive tax planning [2012] OJ L338/41. C(2012) 8806 final.
[26] See, for instance, J. Englisch, *Curbing "abusive" international tax planning under EU law: the case of the Merger Directive* (CISS, 2012).

It certainly does not make it easier to understand or apply, particularly given that many of these concepts are pregnant with meaning accumulated over the years. Secondly, some of the tests and mechanics employed are questionable. One example is given here. For a transaction to be caught by the GAAR its "essential purpose" must be that of avoiding tax.[27] It is then explained that

> "the purpose of an arrangement or series of arrangements consists in avoiding taxation where, regardless of any subjective intentions of the taxpayer, it defeats the object, spirit and purpose of the tax provisions that would otherwise apply."[28]

Reference to a transaction's defeat of the object, spirit or purpose of the law as its "purpose" is strange. Furthermore, if the "purpose of avoiding tax" is to be assessed without having regard to any subjective intentions, taking into account only whether the object, spirit or purpose of the provision is defeated, it does not make sense to require this to be the "essential" purpose. Either the spirit, object and purpose of the law is defeated, or not; this concept cannot be graduated. Thirdly, employing the concept of commercial substance and recharacterising transactions in accordance with their economic substance might be especially challenging in the world of financial transactions. Fourthly, the intended reach of the GAAR is unclear. Take the example of a UK bank wishing to sell shares in a German company to a US bank. As shall be seen, this transaction is subject to the FTT. However, the same economic effect can be reproduced through the purchase and sale of OTC derivatives, which would not be subject to the FTT. Is the GAAR intended to catch such transactions? Preventing FTT avoidance through the use of OTC derivatives amongst financial intuitions established outside participating Member States appears ambitious. It certainly would give rise to enforcement difficulties. Fifthly, the GAAR will not prevent perhaps the most obvious action to avoid the payment of the FTT: relocation of headquarters outside participating Member States or the conversion of branches found outside participating Member States into subsidiaries.[29]

(iii) **Issuance principle.**

The geographical reach of the 2011 Proposal was considerable. A financial institution was deemed to be "established" in a Member State,[30] if it was authorised, had its registered seat, its permanent address, its usual residence, or a branch[31] in that Member State. If a financial institution established outside the EU was a party

[27] Proposal, above fn.1, Art.13(1).
[28] Proposal, above fn.1, Art.(4).
[29] These are discussed in Section II 2(a)(ii) below. See IA, above fn.4, 41–42.
[30] 2011 Proposal, above fn.2, Art.3.
[31] If a financial institution has a branch in a Member State, it is only deemed to be established in that Member State in respect of transactions carried out by that branch—2011 Proposal, above fn.2, Art.3(1)(e). The equivalent provision is found in Proposal, above fn.1, Art.4(1)(e).

to a transaction with a natural person or entity established in a Member State, the financial institution was also deemed to be established in the latter's Member State for the purposes of the tax.[32] Therefore, if, for example, a US bank entered into a financial transaction with a German individual it would be subject to the tax in Germany as would the US branch of a German bank which entered into a financial transaction with a US individual.

Whilst the 2011 Proposal described the tax proposed as adopting the "residence principle", the IA explains that on closer inspection it also adopted the "place of transaction principle".[33] This resulted from the need for financial institutions established outside the EU to obtain authorisation to trade on or with European trading platforms. Both principles have been maintained in the Proposal. In addition, in response to the participating Member States' concerns and on the suggestion of the European Parliament,[34] the Commission added the issuance principle. The Proposal thus adopts all three theoretically possible connecting factors.[35]

As a result of the issuance principle, financial transactions in structured products or financial instruments issued within a participating Member State are subject to the tax even if they are carried out between parties who are not established in a participating Member State.[36] The issuance principle's compliance with public international law is examined in Section III below. Here the authors briefly consider its scope and impact.

OTC derivatives are excluded from the issuance principle. The Proposal, however, is unclear as to the principle's application to derivatives traded on an organised platform. On a wide interpretation, any derivative in which the underlying instrument is issued in a participating Member State is caught. Indeed, this would be in line with the wishes of the Parliament,[37] and is supported by the inclusion of "derivatives" in the definition of "financial transaction" and a passage in the Impact Assessment.[38] On a narrow interpretation, only derivatives that are "issued" in a participating Member State are caught. This is supported by the qualification of "financial instrument" but not "financial transaction" in Article 4(1)(g), the wording of Article 2(11), Article 14(1), the acknowledgement in the IA that such a test

[32] 2011 Proposal, above fn.2, Art.3(1)(e). The equivalent provision is found in Proposal, above fn.1, Art.4(1)(f).
[33] IA, above fn.4, 39–40.
[34] Opinion of the European Parliament of May 23, 2012.
[35] Commission Staff Working Paper, "Impact Assessment, accompanying the document Proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC", SEC(2011) 1102 final of September 28, 2011 (2011 IA).
[36] Proposal, above fn.1, Art.4(1)(g).
[37] "In the case of a derivatives agreement the condition of issuance within the territory of a Member State or of the Union is fulfilled where the reference or underlying instrument is issued by a legal entity that is registered in a Member State". European Parliament Legislative Resolution of May 23, 2012 on the proposal for a Council directive on a common system of financial transaction tax, amendment 18.
[38] "This addition concerns essentially shares, bonds … and derivatives traded on organised trade venues or platforms. In these cases, the transaction has a sufficient connection with the participating Member State in which these instruments are considered to have been issued (i.e. where the *reference entity/company* is residing)." IA, above fn.4, 40 (emphasis added).

might be legally unsound and the expectation that the introduction of the issuance principle would only "supplement to a small extent the tax revenues."[39] Clearly, the impact of the tax would be tremendously increased under the wide interpretation. The adoption of the issuance principle is justified on the grounds of "further strengthen[ing] anti-avoidance of taxation".[40] The Proposal explains that

> "the residence principle is supplemented also by elements of the 'issuance principle' as a last resort, in order to improve the resilience of the system against relocation."[41]

The issuance principle will indeed block avoidance opportunities relying on the relocation of activities or entities outside participating Member States. However, apart from not preventing all avoidance opportunities through relocation, it also goes far beyond its anti-avoidance justification. Simple examples make this clear. If the issuance principle were not introduced, German and French banks could avoid the tax on the purchase and sale of German bonds from one to the other by carrying out the transactions through their UK subsidiaries. As a result of the issuance principle, the purchase and sale between the UK subsidiaries are subject to the FTT. However, the introduction of the issuance principle is not confined to such transactions. For example, it would catch the purchase of German bonds by a UK pension fund from a US bank. The issuance principle thus goes far beyond its anti-avoidance justification by bringing a host of transactions which are not avoidance-driven within the ambit of the tax. It does not merely improve the resilience of the system against relocation, its introduction is tantamount to the introduction of a new tax.

2. The Impact Assessment

The Commission undertook considerable work in producing the voluminous 2011 IA. However, further analysis was required, or at least desirable, in support of the Proposal. First, under the ECP, the FTT is to be adopted by only a subset of Member States. Thought must thus be given to its operation and impact amongst a limited group of participating Member States, as well as the impact on non-participating Member States. Secondly, the novelties found in the Proposal require close examination. Thirdly, whilst the 2011 Proposal was welcomed enthusiastically in some quarters, it also drew considerable criticism. Critics included, as expected, industry participants and lobbyists, but also academics and state institutions, such as the Dutch Central Bank,[42] the Swedish National Debt Office[43] and the UK House of Lords.[44] It would have thus

[39] IA, above fn.4, 40–41.
[40] Proposal, above fn.1, 5.
[41] Proposal, above fn.1, Art.11.
[42] De Nederlandsche Bank, "Financial transaction tax in EU is undesirable", DNBulletin, February 6, 2012.
[43] Swedish National Debt Office, *European Commission proposal for a directive on a common system of taxation on financial transactions* (December 13, 2011).
[44] House of Lords. European Union Committee of the House of Lords, *29th Report of Session 2010–12: Towards a Financial Transaction Tax?* HL Paper No.287 (session 2010/12).

been desirable for the IA to engage with, and ideally rebut, this criticism. This is particularly so given the EU commitment to evidence based policy-making.[45]

The IA's stated purpose is to perform the first two of these three functions[46]; it also indirectly addresses some criticisms. As shall be seen, however, none of these functions is performed in a fully satisfactory manner.

(a) Impact of FTT

(i) **Participating Member States.**

According to the Commission, the expected positive impact for participating Member States consists in the attainment of the FTT's desired objectives. Leaving aside the evaluation of these objectives, the question asked by the authors is whether these objectives can be achieved through the introduction of the FTT amongst a subset of Member States.

The first objective is to tackle the fragmentation of the Internal Market that an uncoordinated introduction of national taxes would create. As explained below, the introduction of the FTT will remove distortions of competition amongst participating Member States (other than those created by different rates). However, it is not evident that the level of distortion within the Internal Market as a whole will be reduced. Furthermore, the IA recognises that double taxation will arise as a result of the proposed FTT, whenever the transaction is also subject to a national FTT of a non-participating Member State. For example, if a German bank sells shares in a UK company to a French bank, the FTT will be due in Germany and France and stamp duty will be due in the UK. The IA states that "these potential occurrences of double taxation should constitute only a tiny fraction of transactions for which the common system of FTT is designed",[47] and provides some back-of-the-envelope calculations on the potential double taxation as a result of the proposed FTT's interaction with UK stamp duty. This might be so, and one acknowledges data issues, however a more comprehensive estimate for the size of this problem would have been preferable.

The second objective is to ensure that financial institutions make a fair and substantial contribution to covering the costs of the recent crisis and to create a level playing field with other sectors from a taxation point of view. Whilst the aggregate revenue raised will be necessarily lower, the proposed FTT's ability to raise revenues should not be affected by its adoption by a subset of Member States. For instance, this is thought not to create significant additional relocation or avoidance opportunities.[48] It is worth noting that the 2011 IA acknowledged that estimating revenues for such taxes "is not feasible without a high degree of

[45] See, for example, Commission Communication, "Smart Regulation in the European Union", COM(2010) 543 final.
[46] IA, above fn.4, 2.
[47] IA, above fn.4, 17.
[48] IA, above fn.4, 50.

uncertainty."[49] The proposed FTT is expected to raise €31 billion per year. The starting point for this forecast is the calculation made for the FTT in the 2011 Proposal. The IA takes the 2011 estimate and scales it by the banking sector's net operating income for the 11 participating Member States. The use of such proxies further weakens the estimate.

The third objective is to create appropriate disincentives for transactions that do not enhance the efficiency of financial markets thereby complementing regulatory measures to avoid future crises. The IA contains no discussion as to whether the adoption of the proposed FTT amongst only a subset of Member States will affect its ability to achieve this objective. To be sure, the FTT will act as a disincentive for "undesirable" (and desirable) transactions in participating Member States. However, given the interconnected nature of financial markets it would have been good to have a discussion of the proposed FTT's ability to positively influence the efficiency of financial markets whilst these "undesirable" transactions still take place elsewhere.

A further issue concerns the fact that regulatory measures in the financial sector are being harmonised for all 27 Member States. As the FTT is considered complementary to these measures, the question is whether this causes problems in determining an adequate level of regulation in a uniform manner for all 27, when only 11 have harmonised complementary measures in place.

The FTT will also produce some negative consequences for participating Member States, however these are not expected to change considerably as a result of its adoption amongst a subset of Member States.

(ii) **Non-Participating Member States.**

The IA does not contain a section that comprehensively assesses the consequences for non-participating Member States. Instead, a few indications are found scattered throughout the document. When considering these consequences, it is important to keep in mind that non-participating Member States will be treated in the same way as non-EU states for the purpose of the FTT. To this extent, London and other financial centres in the non-participating Member States, stand neither to clearly lose out nor to gain over financial centres such as New York or Hong Kong which are outside the EU.

Benefits from the perspective of non-participating Member States Despite the Commission's insistence that "the risk of geographical relocation remains rather limited … so do the benefits",[50] and despite its best efforts to protect against it, it is unavoidable that the FTT will lead to a diversion of institutions, activities and capital from participating Member States to non-participating Member States. As the IA recognises, financial institutions from participating Member States may benefit from setting up subsidiaries in non-participating Member States, or

[49] 2011 IA, above fn.35, 46.
[50] IA, above fn.4, 49.

converting branches in non-participating Member States to subsidiaries.[51] Such subsidiaries will be subject to the FTT on transactions with entities or individuals established in participating Member States as well as transactions involving instruments issued in a participating Member State. However, such subsidiaries will not be subject to the FTT on transactions with entities not established in participating Member States as long as they do not involve financial instruments issued inside participating Member States.

Of course, financial institutions from participating Member States will continue to trade with entities from participating Member States and in instruments issued in participating Member States, however, the considerable benefit of setting up subsidiaries or entities in non-participating Member States and diverting activities to them is clear. Consider a French bank with a subsidiary in London. If the French bank regularly trades with financial institutions from London, New York, Hong Kong and all other major financial centres, or indeed any entity or individual from outside participating Member States, it would benefit considerably by carrying out these activities through its London subsidiary. Furthermore, if financial institutions from participating Member States set up subsidiaries or convert branches into subsidiaries in non-participating Member States they could similarly trade amongst themselves through these subsidiaries rather than through their parent entities in participating Member States. Finally, there are also benefits for a participating Member State financial institution to transact through a non-participating Member State subsidiary even when transacting with an entity or individual from a participating Member State, or when trading instruments issued in a participating Member State. Related transactions, such as hedging, can be carried out with entities from outside the participating Member State thus avoiding the tax on those transactions.

The IA also recognises that financial institutions from participating Member States will have incentives to move their headquarters.[52] By doing so the financial institution would avoid the FTT on transactions in which the counterparty is not established in a participating Member State and the transaction does not involve an instrument issued in a participating Member State. The branches of the financial institution located outside participating Member States will then also avoid the tax to the same extent.

Financial centres outside participating Member States thus stand to gain in terms of the relocation of entities or activities. One would expect these gains not to be insignificant. Whilst the IA recognises these possibilities it does not seek to estimate their potential cost to participating Member States and benefit to non-participating Member States.

One further positive effect for non-participating Member State entities could be their ability to attract capital which might have otherwise flown to participating Member State entities. Take the example of a US fund which is choosing between investing in corporate bonds issued by a French company or a UK company. Assuming the bonds to be identical in all respects save for their susceptibility to the FTT, the FTT could give the US fund an incentive to favour the bonds issued by the UK company. On the other hand, if the FTT is priced into the bonds, the FTT would not affect the US fund's preference but it would increase the cost of capital for the French company relative to the UK company. Therefore, non-participating Member States might benefit

[51] IA, above fn.4, 42–43.
[52] IA, above fn.4, 42–43.

from the FTT because of the relocation of capital to non-participating Member State entities or through the competitive advantage of its entities in terms of a lower cost of capital.

Non-participating Member State entities, including those operating in non-financial sectors, would also enjoy a competitive advantage over participating Member State entities as a result of their ability to use derivatives to hedge their risks free of the FTT charge. As noted in the 2011 IA, as the tax base for derivatives is their nominal value, the FTT charge on derivatives can be very high.[53] If, for example, UK manufacturers are competing with French manufacturers for a contract which involves the purchase of materials from the US, and hence a currency exchange risk, the ability of the UK manufacturer to hedge this risk at a lower cost could prove to be important.

Negative consequences for non-participating Member State The issue of double taxation has been raised under "(i) Participating Member States" above and is not repeated here. A second negative impact relates to the cost incurred by non-participating Member State financial institutions subject to the FTT if they are not able to pass it on. Consider the example of a UK bank entering into a financial transaction with a French bank. The former will be subject to the tax, to be paid to France, and hence an increased cost and lower profits; this could in turn result in lower tax revenues for non-participating Member States. Finally, if the non-participating Member State financial institution can pass on the FTT it might be borne by non-participating Member State citizens. To put this in its most politically inflammatory terms from a UK perspective, if a UK pension fund purchases bonds from a French bank, the tax paid to France could be passed on to UK pensioners.

Further negative consequences could include increased costs for government borrowing, costs of setting up systems to collect the tax and of actually collecting the tax, and consequences flowing from a reduction in financial activity (including lower profits and hence taxes paid to non-participating Member States) and expected changes to current market practices.[54] Of course, at the same time, the non-participating Member States will not benefit from tax revenues raised by the FTT.

The IA does recognise some negative consequences. It notes that as a result of the FTT there might be an increase in the cost of capital in non-participating Member States, however it concludes that this "should at most be a fraction of the (already rather tiny) assumed increase in the cost of capital in EU11+."[55] It also notes that the FTT might lead to an increase in transaction costs, including taxes, for financial institutions in non-participating Member States. These, however, are presented in a somewhat positive light. The increased costs

> "might trigger some changes in business models and other market reactions, such as more intermediation instead of 'spread internalisation', deflating excessive market volumes, reducing the share of high-frequency trading in total turnovers and the frequency of risk hedging operations, or changing to other untaxed activities. In case financial institutions of

[53] IA 2011, above fn.35, 21–22.
[54] The Commission notes that to avoid the cascading effect of the tax, financial intermediaries could transfer financial instruments from one to the other as agents rather than principals. The Commission does not consider whether this change in practice could produce negative consequences, such as more complex bankruptcy actions.
[55] IA, above fn.4, 46.

> [non-participating Member State] were not able to pass this tax on to their client base or counter parties from the FTT jurisdiction this might eventually trigger some compression of rents earned in the past with such transactions, although the expected rates of return of the individual transactions should still remain positive."[56]

There might be some validity in parts of this explanation, however, its overall positive tone does not fully convince. Talk of "excessive market volumes" begs a number of questions starting with the meaning of "excessive". The existing evidence on the impact of high-frequency trading on market efficiency is inconclusive making the result of a reduction of this form of trading unclear. Furthermore, once these consequences for non-participating Member States were recognised, a deeper analysis, with possible estimates of the expected impact, was necessary in order to allow non-participating Member States to make a properly informed decision on the FTT.

Overall the considerations raised here lead to the conclusion that it is not clear whether the FTT will have a net positive or negative effect on non-participating Member States. Of course, the impact could vary between Member States depending, amongst other things, on the size and importance of their financial sector. A comprehensive and transparent consideration of these issues in the IA would have been highly desirable.

(b) Justification of changes made

The IA considered a number of changes to the 2011 Proposal. The authors focus here on the changes relating to avoidance.[57]

The IA provides some analysis of the expected impact of the issuance principle. It explains that the issuance principle will

> "catch another significant portion (about 10%) of financial transactions in shares issued by EU11 entities and of transactions in debt securities issued by EU11 entities (not captured by using the residence principle), which would yield as revenues EUR 0.39 bn. from taxing shares and 0.83 bn. from taxing bonds and bills."[58]

The first point to note here is that the analysis is limited to shares and debt, whilst, of course, the scope of the FTT is much broader. Also, this estimate of the portion of transactions caught by the issuance principle is based on an IMF survey and the Commission's own calculation but these are not presented in the IA. Finally, the revenue estimates are based on rough calculations.[59] Overall, therefore, the analysis presented is extremely limited.

The IA contains no discussion of the type of activity the GAAR is intended to target, nor of its expected operation and impact.

[56] IA, above fn.4, 46–47.
[57] Note however, that some of the other changes are expected to have considerable effect, which the IA seeks to estimate. See, for example, IA, above fn.4, 28–29.
[58] IA, above fn.4, 40.
[59] IA, above fn.4, 40, at fn.59.

(c) Criticism of the 2011 Proposal and Impact Assessment

The criticism levelled at the 2011 Proposal and IA, focused on a variety of issues. The first strand of criticism focused on broad issues. One of this article's authors argued that the case for some of the FTT's objectives had not been made.[60] For example, the objective of "creating appropriate disincentives for transactions that do not enhance the efficiency of financial markets" was directed primarily at high frequency trading but the Commission itself has admitted that "[e]xisting evidence is inconclusive about the impact of HFT on market efficiency."[61] The author also argued that the case for choosing the FTT as the instrument to achieve these objectives had not been made. For example, the objective of raising revenue from the financial sector is partly justified to compensate for the alleged under-taxation resulting from the VAT exemption of financial services. As the Commission itself noted, however, "transaction taxes … are not really effective to compensate for the VAT exemption …"[62] Further criticism was directed at some of the fundamental aspects of FTTs in general. For example, it is thought that the FTT, which is meant to raise revenue from the financial sector, is likely to be borne by final consumers.[63] Criticism on these broad issues was not addressed in the IA.

A second strand of criticism was directed at the Commission's estimation of the FTT's macro-economic effects.[64] The authors do not seek to adjudicate on the matter, however, the criticism raises reasonable questions. It is thus disappointing that the IA merely lists the papers which put forward this criticism but does not address it. It should also be pointed out that the Commission's argument as to the possible positive impact of the FTT on growth if the revenues raised are used for productive public investment is misleading. Any positive impact would be related to the spending of the revenues and not the manner in which those revenues are raised.

A third strand was directed at the design of the tax. Some of this criticism was addressed, albeit with variable adequacy. For example, criticism relating to the taxation of government debt is not dealt with in a convincing manner and whilst criticism relating to the treatment of repos and reverse repos led to some changes, as discussed above, serious concerns remain about the impact of taxing these transactions.

Overall, the Commission's engagement with criticism made of its 2011 Proposal is not entirely satisfactory.

[60] Vella, et al., above fn.3.
[61] European Commission, "Public consultation: review of the markets in financial instruments directive (MiFID)" (December 2010), 14.
[62] 2011 IA, above fn.35, 34–35.
[63] The IA notes: "[i]n case financial institutions of [non-participating Member States] were not able to pass this tax on to their client base or counter parties from the FTT jurisdiction". IA, above fn.4, 47.
[64] OXERA, "What would be the economic impact on the EU of the proposed financial transaction tax? Review of the European Commission's impact assessment" (2011); OXERA, "What would be the economic impact on the EU of the proposed financial transaction tax? Review of the European Commission's latest commentary" (2012).

III. Compatibility of extraterritorial effects with public international law

1. Extraterritorial effects

The geographical scope of the proposed tax rests on three pillars, which are listed in Article 4 of the Proposal under the misleading heading "establishment": (i) the "residence principle" *strictu sensu* (paragraphs 1(c)–(e) and 2(a)–(b)); (ii) the "place of transaction principle" (paragraph 1(a)–(b))[65]; and finally (iii) the "issuance principle" (paragraphs 1(g) and 2(c)).[66] There are extraterritorial effects inherent in all three principles. By virtue of the first two principles, the taxable object could lack territorial nexus, because dealings in instruments that have been issued and registered in other Member States or in third countries could attract FTT. Regarding the taxable person, the "place of transaction principle" would imply that financial institutions and other persons can become liable for FTT even though they have no seat, establishment or domicile in one of the participating Member States. Finally, the issuance principle would extend those "subjective" extraterritorial effects to situations where even the taxable transaction has been realised on a trading platform outside the participating Member States.

The extraterritorial effects of the residence principle and of the place of transaction principle are further aggravated by what could best be described as the "contagion effect": when a financial institution fulfils none of the criteria relied on in Article 4(1)(a)–(e) of the Proposal, it shall nevertheless become liable to the FTT if the counterparty involved in the taxable transaction is (deemed to be) established in a participating Member State pursuant to Article 4(1)(a)–(e) or (2)(a).[67] For example, a US bank that trades stock options in a US corporation with the US branch of a German bank OTC in New York will be liable to pay FTT on this transaction by virtue of Article 4(1)(c) read together with Article 4(1)(f) of the Proposal.

In the following sections, the authors will analyse the extraterritorial effects of the Proposal with a view to their compatibility with public international law. It should be noted that international law remains relevant also in the relations between participating Member States and non-participating Member States. In particular, the authorisation to proceed with the enhanced cooperation granted by the Council cannot be regarded as an endorsement by non-participating Member States of all eventual extraterritorial effects, particularly as the details of the future legislation are as yet undecided.

2. Customary international law as a binding limit on extraterritorial effects

(a) EU law relevance of customary international law

It is settled case law of the Court of Justice of the European Union (CJEU) that the EU must respect customary international law in the exercise of its powers.[68] The Grand Chamber of the CJEU has only recently confirmed that customary international law is binding upon the institutions

[65] See IA, above fn.4, 39.
[66] See Proposal, above fn.1, 11.
[67] Proposal, above fn.1, Art.4(1)(f).
[68] See, e.g. *Anklagemyndigheden (Public Prosecutor) v Poulsen and Diva Navigation* (C-286/90) (*Poulsen and Diva*) [1992] ECR I-6019 (European Court of Justice) at [9]; *Racke GmbH & Co v Hauptzollamt Mainz* (C-162/96) [1998] ECR I-3655 (European Court of Justice) at [45]–[46].

of the EU when they adopt an act of legislation.[69] Secondary EU law that fails to conform to customary international law is therefore void. Admittedly, the CJEU has also indicated that it would exercise a restrained review rather than strict scrutiny in this regard, taking into account that a principle of customary international law does not have the same degree of precision as a provision of an international agreement. The CJEU will therefore limit its standard of review to a "manifest error" test.[70]

(b) Customary international law requirement of an adequate territorial link

Against this background, it is necessary to determine the principles of customary international law that might be contravened by the extraterritorial effects inherent in the proposed FTT legislation.[71]

(i) General observations The inevitable point of departure is the famous *Lotus* decision delivered by the Permanent Court of International Justice (PCIJ) in 1927.[72] The PCIJ distinguished between the jurisdiction to prescribe[73] and the jurisdiction to enforce national law. It held that the latter was clearly restricted by the territoriality principle, in that a State may not exercise its power in any form in the territory of another State.[74] By contrast, the PCIJ decided that "at present", States were under no general obligation to refrain from applying their laws to persons, property and acts outside their territory.[75]

Public international law restrictions on extraterritorial effects have, however, tightened in the post-Second World War era.[76] While there is still no absolute prohibition to exercise prescriptive jurisdiction extra-territorially, the bases of such jurisdiction are now held to be defined and limited by the sovereign territorial rights of the other relevant States, as has been pointed out by the Grand Chamber of the European Court of Human Rights[77] in conformity with scholarly

[69] *Air Transport Association of America and Others v Secretary of State for Energy and Climate Change* (C-366/10) (*Air Transport Association of America*) [2012] 2 CMLR 4 (European Court of Justice) at [101]–[102].
[70] *Air Transport Association of America*, above fn.69, [2012] 2 CMLR 4 at [110].
[71] This article will not discuss the interplay between double tax conventions and the Proposal, such as a potential breach of Article 29(4) of the DTC between the US and France.
[72] PCIJ, 7 September 1927, *The Case of the S.S. "Lotus" (France, Turkey)*, PCIJ Series A, No.10 (1927).
[73] Also referred to as legislative jurisdiction, see R.S. Martha, *The Jurisdiction to Tax in International Law* (Deventer: Kluwer, 1989), 67, with further references. See also C. Ryngaert, *Jurisdiction in International Law* (Oxford: OUP, 2008), 9.
[74] See *Lotus*, above fn.72, PCIJ Series A, No.10 (1927) at 18 et seq. This principle is still customary international law; see, e.g. I. Brownlie, *Principles of Public International Law*, 8th edn (Oxford: OUP, 2012), 478–479; H.L. Buxbaum, "Territory, Territoriality, and the Resolution of Jurisdictional Conflict" (2009) 57 Am. J. Comp. L. 631, 664. For a detailed analysis, see F.A. Mann, "The Doctrine of Jurisdiction in International Law" (1964) 1 RdC 9, 127 et seq.
[75] See *Lotus*, above fn.72, PCIJ Series A, No.10 (1927) at 19. See also, in a similar vein, *Evatt J, Trustees Executors & Agency Co Ltd v Federal Commissioner of Taxation*, 49 CLR 220 (June 8, 1933, High Court of Australia) at 238–239.
[76] See Opinion of Judge Alvarez, *The Case of Fisheries*, I.C.J. Reports 1951 at 152; Declaration of President Bedjaoui, July 8, 1996, Advisory Opinion on the Legality of the Threat or Use of Nuclear Weapons at [15]; Opinion of Judge Weeramantry, July 8, 1996, Advisory Opinion on the Legality of the Threat or Use of Nuclear Weapons at 273–274. See also Ryngaert, above fn.73, 26 et seq.
[77] *Banković and Others v Belgium and 16 Other Contracting States*, Application No.52207/99 (European Court of Human Rights, December 12, 2001) at [59].

writings.[78] It has been universally accepted for some considerable time that it is incumbent upon States to show a degree of moderation and restraint in the exercise of their sovereign powers. They must choose criteria or connecting factors as bases for their legislative jurisdiction which have a substantial—albeit broadly defined—link[79] to either their territory ("territoriality principle") or to their nationals ("personality principle").[80] The CJEU has accepted, too, that the principle of territoriality limits the exercise of the EU's legislative powers,[81] at least when no recourse can be had to the personality principle or, exceptionally, to the principle of universal jurisdiction.[82]

Section 402(1) of the *American Law Institute's Restatement (Third) of the Foreign Relations Law of the United States*[83] correctly reflects the main connecting factors that can be regarded as legitimate under the territoriality principle: (a) conduct that, wholly or in substantial part, takes place within the state's territory; (b) the status of persons, or interests in things, present within the state's territory; or (c) conduct outside the state's territory that has or is intended to have substantial effect within its territory.[84] The last mentioned principle (known as the "effects doctrine" or "objective territoriality principle") is understood only to authorise measures which are directed against potentially *harmful* effects of the regulated conduct.[85] For instance, this principle is recognised as a basis for extraterritorial effects of Union competition law.[86]

It is further suggested by prominent scholars that whether or not a territorial link is sufficiently relevant and thus "genuine" or "substantial" must be determined in the light of the subject-matter

[78] The European Court of Human Rights cited, i.a., F.A. Mann, *The Doctrine of Jurisdiction in International Law, Twenty Years Later*, Vol.3 (1984), 9; R. Bernhardt, "Encyclopaedia of Public International Law" (1997, Vol.3), 55–59 "Jurisdiction of States" and (1995, Vol.2) 337–343 "Extra-territorial Effects of Administrative, Judicial and Legislative Acts"; L.F.L. Oppenheim, *Oppenheim's International Law*, Vol.1, 9th edn (Longman, 1992), §137; P.M. Dupuy, *Droit International Public*, 4th edn (Dalloz-Sirey, 1998), 61; and I. Brownlie, *Principles of International Law*, 5th edn (Oxford: OUP, 1998), 287, 301, 312–314.

[79] The "genuine link" requirement was first formulated as such by F.A. Mann, "The Doctrine of Jurisdiction in International Law" (1964) 1 RdC 9, 46: "… a close … connection with the facts, a genuine link, a sufficiently strong interest".

[80] F.A. Mann's formula has been generally accepted and refined; see, e.g. US Court of Appeals, March 6, 1984, *731 F.2d 909* at 921–922; German Constitutional Court, January 30, 2008 (2 BvR 793/07) [2008] NVwZ 878 at 879; AG Kokott Opinion of October 6, 2011, *Air Transport Association of America*, above fn.69, [2012] 2 CMLR 4 at [159]; American Law Institute (ALI), *Restatement of the Law, Foreign Relations of the United States*, Vol.1, 3rd edn (1987), §402; J.H. Currie, *Public International Law* (Toronto: Irwin Law, 2001), 298–299; Brownlie, above fn.78, 457; Oppenheim, above fn.78, 457–458; Ryngaert, above fn.73, 22; V. Epping and C. Gloria, in Ipsen (ed.), *Völkerrecht*, 5th edn (Munich: Beck, 2004), §23, para.88; T. Stein and C. von Buttlar, *Völkerrecht*, 13th edn (Munich: Vahlen, 2012), para.606; A. Verdross and B. Simma, *Universelles Völkerrecht*, 3rd edn (Berlin: Duncker & Humblot, 1984), §1183; M. Herdegen, *Völkerrecht*, 11th edn (Munich: Beck, 2012), §26, paras 1 et seq.

[81] See *Ahlström Osakeyhtiö and Others v Commission* ("Wood pulp") (C-89/85 and others) [1988] ECR 5193 (European Court of Justice) at [18]. See, in this regard, also K. Lenaerts and P. Van Nuffel, *European Union Law*, 3rd edn (London: Sweet & Maxwell, 2011), para.22-055; J. Kokott in Streinz (ed.), *EUV/AEUV*, 2nd edn (Munich: Beck, 2012), Art.47 EUV, para.20.

[82] Universal jurisdiction is limited to certain areas of international criminal law; see W. Estey, "The Five Bases of Extraterritorial Jurisdiction" (1997) 21 Hastings Int'l and Comp. L. Rev. 177, 195 et seq.

[83] American Law Institute, *Restatement of the Law. The Foreign Relations of the United States*, Vol.1, 3rd edn (St Paul, Minn: American Law Institute, 1987), §§1–488.

[84] The "effects principle" had indeed already been mentioned as a possible connecting factor in *Lotus*, above fn.72, PCIJ Series A, No.10 (1927) at 23.

[85] See Brownlie, above fn.78, 462–463; Estey, above fn.82, 186; J.-G. Castel, *The Extraterritorial Effects of Antitrust Laws*, Vol.1 (1983) 25, 28–29; H.G. Maier, "Jurisdictional Rules in Customary International Law" in Meessen (ed.), *Extraterritorial Jurisdiction in Theory and Practice* (The Hague: Martinus Nijhoff, 1996), 64, 66–67.

[86] See *Gencor Ltd v Commission of the European Communities* (T-102/96) [1999] ECR II-753 (CFI) at [90], [92].

and the objectives of the legislation in issue.[87] Finally, the exercise of the jurisdiction to prescribe should be reasonably related to the (stricter) territorial limits on enforcement jurisdiction.[88] While it is disputed whether a "reasonableness" requirement can already be regarded as international customary law,[89] it certainly reflects a strong tendency in the adjudication of public international law cases.[90] At the very least, foreseeable and inevitable large-scale difficulties in enforcing certain provisions due to their extraterritorial dimension are *indicative* of a lack of a sufficiently close connection which is required for the jurisdiction to prescribe.

(ii) Implications for the jurisdiction to tax Obviously, the enactment of tax statutes or, in the case of the EU, the enactment of regulations and directives intended to harmonise national tax systems constitutes an exercise of the jurisdiction to prescribe. In the light of the conclusions discussed under "General Observations" above, extraterritorial effects must therefore be justified either by the territoriality principle or by the personality principle.[91] The imposition of a tax liability without any or with only a very remote connection to the state which is imposing it does not respect the sovereign rights of other states that have a close(r) nexus to the respective—and indeed limited—taxpaying capacity, or that have, in the case of extra-fiscal tax policy objectives, a (more) relevant interest in regulating—or not—taxpayer conduct. In this sense, there must be a "relevant and definite" link between a state and the person, property or transaction that it seeks to tax.[92] The opposite opinion, specifically that of unlimited legislative jurisdiction, has essentially been overcome, albeit with some delay, in the wake of the general developments in public international law referred to above.[93] It has moreover always been accepted as customary

[87] See, in this regard, Brownlie, above fn.78, 457; A.V. Lowe, "The Problems of Extraterritorial Jurisdiction" (1985) 34 Int'l and Comp. L.Q. 724, 735; Ryngaert, above fn.73, 212–214; G. Burmester, *Grundlagen internationaler Regelungskumulation und -kollision, unter besonderer Berücksichtigung des Steuerrechts* (Baden-Baden: Nomos, 1993), 61; G. Dahm, J. Delbrück and R. Wolfrum, *Völkerrecht*, Vol.I/1, 2nd edn (Berlin: de Gruyter, 1989), 321; Epping and Gloria, above fn.80, §23, paras 88 and 90; T. Stein and C. von Buttlar, *Völkerrecht*, 13th edn (Vahlen, 2012), para.608.

[88] See Buxbaum, above fn.74, 665, with further references. This is also conceded by A.H. Qureshi, "The Freedom of a State to Legislate in Fiscal Matters under General International Law" [1987] IBFD Bulletin 14, 21. For a different opinion, see Mann, above fn.79, 34 et seq.; R.J. Jeffery, *The Impact of State Sovereignty on Global Trade and International Taxation* (Alphen aan den Rijn: Kluwer Law International, 1999), 43; German Supreme Tax Court (BFH), December 18, 1963, I 230/61, [1964] BStBl. III, 253, para.37.

[89] See Maier, above fn.85, 73; Ryngaert, above fn.73, 178 et seq., with further references.

[90] See D.B. Massey, "How the American Law Institute influences Customary Law: The Reasonableness Requirement of the Restatement of Foreign Relations Law" (1997) 22 Yale J. Int'l L. 419 et seq.

[91] See, i.a. *Miller Bros Co v State of Md* 347 U.S. 340 (US Supreme Court April 5, 1954) at 342 (regarding both, inter-state and international extraterritorial effects); W. Schön, "Persons and Territories: on the International Allocation of Taxing Rights" [2010] BTR 554. Likewise M. Akehurst, "Jurisdiction in International Law" (1972–1973) 46 BYIL 145 at 178–179; Martha, above fn.73, 47; J.E. Bischel and R. Feinschreiber, *Fundamentals of International Taxation* (Practising Law Institute, 1977), 6; Burmester, above fn.87, 279; K. Vogel in Vogel and Lehner (eds), *Doppelbesteuerungsabkommen*, 5th edn (Munich: Beck, 2008), Einleitung para.11; B. Zuber, *Anknüpfungsmerkmale und Reichweite der internationalen Besteuerung* (Hamburg: Steuer- und Wirtschaftsverlag, 1991), 82 et seq.; H. Schaumburg, *Internationales Steuerrecht*, 3rd edn (Cologne: Otto Schmidt, 2011), para.13.1.

[92] See Mann, above fn.74, 110–111; German Constitutional Court, March 22, 1983 (2 BvR 475/78) 43 BVerfGE 343 at 369.

[93] Only very few authors still pleaded for this view in the last 30 years; see, e.g. Qureshi, above fn.88, 16 et seq.; S. Picciotto, *International Business Taxation* (London: Weidenfeld & Nicholson, 1992), 307.

international law that tax claims cannot be enforced beyond the territory of the state that levies the tax, unless international law expressly provides otherwise.[94]

Section 411(3)(b) of the *Restatement (Third) of the Foreign Relations Law of the United States* correctly states that extraterritorial effects of a transaction tax such as FTT can only be justified if the taxed transaction "occurs, originates, or terminates in the state's territory or has some other substantial connection to the state." It should be added that the "other substantial connection" can only be affirmed if either nationals are a party to the transaction, or if a substantial territorial link within the meaning of Section 402 (1) of the said Restatement exists (especially objective territoriality).

3. An analysis of the Commission's Proposal

(a) The residence principle and the place of transaction principle

The residence principle underlying Article 4(1)(c)–(e), (2)(a)–(b) of the Proposal and the ensuing extraterritorial effects can be justified by recourse to the territoriality principle of international law. It has already been pointed out that the territorial presence of persons is a sufficiently relevant connecting factor in order to regulate and also tax their activities, even beyond national borders. With regard to financial institutions which are seated within a participating Member State, taxation could be also based on the personality principle.[95] The place of taxation principle embodied in Article 4(1)(a)–(b) of the Proposal passes the "genuine link" test, too. Here, it is the economic activity that takes place within the state's territory that justifies the corresponding tax liability, irrespective of any territorial connection of the acting person herself.

It is noteworthy that with regard to both of the aforementioned principles, the imposition of a tax also corresponds to the main tax policy aspects of the FTT proposal, i.e. to ensure that the financial sector in the participating Member State contributes a "fair share" to the expenses of the public purse. Financial institutions established in participating Member States have presumably benefited from public spending in the context of the financial crisis, and those using trading platforms in these states also benefit from stable and liquid financial markets.

The authors would, however, like to question whether the extraterritorial "contagion effects" of the residence principle that are laid down in Article 4(1)(f) of the Proposal can also be defended. The Commission has not explained why financial institutions established outside the participating Member States shall become liable for FTT merely on grounds that the counterparty to that transaction, or the financial institution acting on its behalf, is (deemed to be) established in a participating Member State. Quite the contrary, in the 2011 IA, the Commission maintained—convincingly—that the residence principle implies non-taxation of the leg of a trade that is a non-resident buyer or seller.[96] It is also not clear why a financial institution that is neither established in one of the participating Member States nor relies on the financial market

[94] See, e.g. D.G. Hill, "Constitutional Power and Extraterritorial Enforcement" (1996) 19 UNSW Law Journal 45, 57; German Constitutional Court, March 22, 1983 (2 BvR 475/78) 43 BVerfGE 343 at [68]–[69]; O. Bühler, *Prinzipien des Internationalen Steuerrechts* (Amsterdam: Internationales Steuerdokumentationsbüro, 1964), 132.
[95] Some would even conclude the same for the taxation of the activities of a domestic branch; cf. Estey, above fn.82, 185, 186.
[96] 2011 IA, above fn.35, 5.

infrastructure of a participating Member State should contribute a "fair share" to the revenue needs of participating Member States. The argument of under taxation of the financial sector seems to be a very weak one in this context, too, because there will be an FTT liability already in respect of the other—"resident"—financial institution involved in the trade. Neither, and at least with respect to financial institutions established outside the EU, is enforcement of the tax facilitated by creating an additional taxpayer; indeed, the contrary seems to be the case.

(b) The issuance principle

Another problematic aspect is the extraterritorial effects of taxation based on the issuance principle laid down in Article 4(1)(g), (2)(c) of the Proposal. At the outset, the authors would like to recall that the crucial question as to whether a significant and genuine, sufficiently relevant territorial link exists between the taxable object and the state imposing the tax liability cannot be answered without regard being had to the objectives and purpose of the legislation in issue. The Proposal has been put forward with the explicit intention of ensuring that the financial sector contributes more fairly to the costs of dealing with the financial crisis, and to compensate for the presumed VAT under-taxation of the sector.[97] However, when a transaction is carried out without using an EU trading platform and when the financial institutions involved also do not have a business presence in the participating Member States (otherwise, tax will already be levied based on the residence or place of transaction principles), this transaction is not connected at all to the attainment of the aforementioned objectives. In any event, it would not attract VAT in a participating Member State, even if the financial sector was subject to VAT, on the grounds of a lack of a relevant proxy indicating consumption within the participating Member States. Furthermore, it is not clear why a transaction that does not imply any involvement of the financial sector of a participating Member State, or of its securities market infrastructure, should be relied on to make good for the costs of the financial crisis in that state.

Besides the aforementioned main objectives of the proposed FTT, its levy also seeks to create "appropriate disincentives for transactions that do not enhance the efficiency of financial markets",[98] albeit only as a "welcome side effect".[99] It can be assumed that this rather cryptic expression refers to the objective of discouraging high-frequency trading, which is suspected by some to increase volatility of equity markets, as well as market distress in case of external shocks.[100] Leaving aside the validity of this objective, it could be argued that a stock market crisis possibly caused by high-frequency trading outside the participating Member States would inevitably also have adverse effects on markets of the participating Member States; preventive measures could therefore seemingly be regarded as justified under the effects doctrine developed in the PCIJ *Lotus* case.[101] Upon a closer look this would, however, be a weak argument. First, high-frequency trading affects stock markets primarily, but the issuance principle of Article 4(1)(g), (2)(c) of the Proposal is not limited to transactions in shares. Secondly, the issuance

[97] See Proposal, above fn.1, 2, 4.
[98] See Proposal, above fn.1, 2.
[99] See IA, above fn.4, 11 (in fn.17).
[100] See M.J. McGowan, "The Rise of Computerized High Frequency Trading: Use and Controversy" [2010] 16 *Duke Law and Technology Review* [43]–[46] with further references.
[101] *Lotus*, above fn.72, PCIJ Series A, No.10 (1927).

principle is obviously ineffective as regards averting presumed harmful effects caused by high-frequency trading on platforms outside the participating Member States, since the principle will cover only a small portion of the stock traded on foreign platforms. This is particularly true for the most important foreign jurisdiction, i.e. for US stock markets, where European stocks are usually traded in the form of American depositary receipts which are issued by an American depository bank and which should therefore not be affected by the proposed FTT under the issuance principle.[102] Therefore, the territorial link that at first sight might be construed as being based on the secondary aim of the FTT proposal is actually too remote to be considered relevant.

The conclusions referred to above are also valid when account is taken of the special purpose of the issuance principle, which has been included in the proposal as an anti-relocation measure.[103] It is not admissible, under public international law, to prescribe taxation with extraterritorial effects merely on the grounds of neutralising the negative "territorial effects" of domestic taxation, in the absence of any other relevant personal or territorial link. In particular, such legislation cannot be justified under the effects doctrine.[104] Any "harmful" relocation effects in the financial sector would not be an immediate *result* of extraterritorial conduct, i.e. of securities transactions outside the participating Member States. Quite the contrary, this apprehended conduct would be *caused by* FTT legislation, as a direct consequence of tax law disparities between sovereign states. However, without any more specific territorial link, the mere promotion of national economic policy objectives does not constitute a sufficient link by the standards of public international law.[105]

Moreover, the strict customary international law limits to extraterritorial enforcement of tax claims possibly render the issuance principle unreasonable under the current proposal, at least to the extent that the taxable transactions are realised by or through financial institutions without a business presence in the EU.[106] Admittedly, there exist certain instruments for mutual assistance regarding the enforcement of tax claims beyond the EU.[107] However, they are likely to be even less effective than the EU mechanisms which so far yield only very unsatisfactory results.

What is the Commission's reasoning in this regard? In its Questions and Answers memo, the Commission maintains, first, that the issuance principle corresponds to the internationally accepted destination principle in VAT systems, which can also lead to domestic taxation of non-established

[102] The assertion to the contrary in the IA, above fn.4, 40, fn.57, is not covered any more by the Proposal, above fn.1, due to a changed approach; see Art.2(11). The anti-avoidance provision of Art.14 of the Proposal should normally be inapplicable, since American depositary receipts are an established trading instrument that offers a range of advantages and whose essential purpose is therefore not to avoid FTT.
[103] See Proposal, above fn.1, 5, 11; for a detailed analysis, see above at Section II 1(b)(iii).
[104] Discussed above at Section III 2(b)(i).
[105] See Mann, above fn.79, 49; A. Bianchi, "Jurisdictional Rules in Customary International Law (Discussant)" in Meessen (ed.), *Extraterritorial Jurisdiction in Theory and Practice* (London, Boston: Kluwer Law International, 1996), 87–88.
[106] With a view to financial institutions and other taxable persons who are established in a NPMS, tax supervision and enforcement are facilitated by the Directive 2011/16/EU on administrative cooperation in the field of taxation and by Directive 2010/24/EU concerning mutual assistance for the recovery of claims relating to taxes. See also J. Tiley and G. Loutzenhiser, *Advanced Topics in Revenue Law* (Oxford: Hart Publishing, 2013), 331.
[107] Most notably, the *OECD—Council of Europe Multilateral Convention on Mutual Administrative Assistance in Tax Matters*, referred to by the Commission in its Proposal, above fn.1, 14.

businesses.[108] It is respectfully submitted, though, that such a comparison does not hold. VAT is by definition and by design a tax on consumption, as expressly laid down in Article 1(2) of the VAT Directive.[109] In such a context, a *relevant* economic link sufficiently related to the conception and inherent logic of the tax can indeed be presumed if the traded good or service is consumed, or if it can reasonably be presumed to be consumed, in the territory of the taxing state. Moreover, in the example used by the Commission—a B2C digital supply from a third country—taxation is actually based on the residence principle (see Article 58 VAT Directive).

The Commission makes a stronger argument by pointing out that the UK Stamp Duty Reserve Tax (SDRT) is also based on the issuance principle, and its extraterritorial effects seem to have been accepted by other states.[110] However, the comparison with SDRT appears questionable. In this context, it is necessary to reiterate that an assessment of a sufficiently relevant, "genuine" territorial link can only be assessed in the light of the objectives of the legislation and its extraterritorial effects. Like other stamp duties, the UK stamp duty has evolved historically as a tax upon the use of certain instruments needed to give effect to an agreed change in (share) ownership and its eventual registration.[111] SDRT was introduced as a complementary tax—even though it quickly became the main source of revenue—when electronic settlement of share transactions was introduced in the London stock market. It was thus clearly conceived as a tax on the use of domestic electronic settlement and registration systems; more specifically, the CREST system operated by Euroclear. Consequently, its design permits the bulk of revenue to be collected automatically by CREST, rather than by the financial institutions, or other parties, trading the securities. Moreover, important exemptions were introduced for overseas exchange traded funds and for other operators.[112] Thus, while foreign "off-market" transactions of shares in UK corporations also caught by the SDRT cannot be explained by the original logic underlying the levy of this tax, they are comparatively few in number and therefore they were unlikely to raise any international objections. In addition, even they can be justified if one characterises SDRT as a special indirect tax on capital, as some authors do.[113] A tax on capital levied by the country where the intangible representing the capital investment is "located", as determined by the issuance principle, can possibly be defended in the light of the territoriality principle,[114] at least to the extent that it can reasonably be expected to be collected by institutions and

[108] See Commission Memo 13/98, "Financial Transaction Tax through Enhanced Cooperation, Questions and Answers" (Brussels: February 14, 2013).
[109] Council Directive 2006/112/EC of November 28, 2006 on the common system of value added tax (the VAT Directive).
[110] See IA, above fn.4, 40.
[111] See J. Mirrlees, et al., *Tax by Design: The Mirrlees Review* (Oxford: OUP, 2011), 148, 151; J.A. Kay and M.A. King, *The British Tax System*, 5th edn (Oxford: OUP, 1990), 204; see also *Allders International Pty Ltd v Commissioner of State Revenue (Vic)*, 186 CLR 630 (November 14, 1996, High Court of Australia, Dawson J) at 653.
[112] See R.S. Nock, *Monroe & Nock on the Law of Stamp Duties* (London: Sweet & Maxwell, 1989, loose-leaf, last release in November 2012), paras 4.241–4.243.
[113] See S. Adam, J. Browne and C. Heady, "Taxation in the UK" in Mirrlees, et al. (eds), *Dimensions of Tax Design: the Mirrlees Review* (Oxford: OUP, 2010), 1, 21; see also Nock, above fn.112, paras 4.021 and 4.025.
[114] See also *Burnet v Brooks*, 288 U.S. 378 (March 13, 1933, US Supreme Court) at 396–397; however, the reasoning in this decision was based on similar considerations as the ones underlying the PCIJ ruling in *Lotus*, above fn.72, PCIJ Series A, No.10 (1927), and did not reflect the subsequent developments of public international law mentioned above at 3.2.2.(i). See furthermore, concerning estate taxes, *Winans v Attorney General (No.2)* [1910] A.C. 27 (HL); *Johnson v Stamp Duties Commissioner* [1956] A.C. 331 (Privy Council (Australia)) at 354.

intermediaries (e.g. stockbrokers) which are established domestically.[115] It is also this common conception of a transaction tax that has probably led the American Law Institute to assume that taxable transactions having a substantial connection to a state include transfers of shares (not: derivatives) in companies domiciled in that state[116]; otherwise, this position would be untenable.

By contrast, the FTT proposed by the Commission is supposed to tax the financial sector rather than capital investment, on the grounds of the fiscal and extra-fiscal policy reasons discussed above that are entirely unrelated to the location of the companies whose shares are traded. Moreover, in the context of the FTT proposal the issuance principle is not a proxy for the use of domestic settlement and registration systems, since these scenarios are already fully covered by the "place of transaction principle" of Article 4(1)(a)–(b) of the Proposal. Against this background, the extent to which the reference to the SDRT allows for the conclusion that the issuance principle respects the "genuine link" requirement is questionable. Moreover, as has already been mentioned, the proposal in its current form is quite possibly not reasonably related to the limits of enforcement jurisdiction which is different from the SDRT collection mechanism.

Section II(1)(b)(iii) noted the two possible interpretations of the application of the issuance principle to derivatives. The arguments in the present section are presented with the narrow interpretation in mind. If the wide interpretation were correct, meaning a derivative is caught by the issuance principle if the underlying instrument was issued in a participating Member State, the issuance principle's compliance with international law becomes even less tenable.

Finally, it is doubtful whether the above mentioned concerns are adequately addressed by the escape clause of Article 4(3) of the Proposal, pursuant to which a taxable person will not be liable for payment of FTT where this person "proves that there is no link between the economic substance of the transaction and the territory of any participating Member State". As seen above, the questions surrounding the compliance of Articles 4(1)(g) and (2)(c) with public international law are not confined to particular situations arising under the issuance principle, which might be remedied by recourse to Article 4(3). Instead, the questions relate to the conformity of the issuance principle per se with the "genuine and relevant link" requirement of the territoriality principle in the specific context of the FTT Directive. Since the escape clause puts the onus of proof entirely on the taxable person, this further compromises the suitability of Article 4(3) as a safeguard provision for keeping extraterritorial effects within reasonable limits.[117]

As a caveat, it should be pointed out that it is uncertain whether the CJEU will come to the same conclusions based on its lenient "manifest error" test.[118] The CJEU might refrain from a scrupulous analysis of the "genuine link" requirement due to the fact that, superficially, the FTT seems comparable in this regard to some traditional national stamp duties or transaction taxes, and to SDRT in particular.

[115] As regards the relevance of taking into account the stricter territorial limits on enforcement jurisdiction, see above at Section III 2(b)(i).
[116] See s.412(4) and the corresponding comments (f) and (i) of the American Law Institute, above fn.83.
[117] See, in a similar vein, Lowe, above fn.87, 736.
[118] See above at Section III 2(a).

(c) The escape clause of Article 4(3) of the Proposal

The authors would like to conclude this section with some further comments on the aforementioned escape clause of Article 4(3) of the Proposal. Should the Proposal be adopted without moderating amendments regarding its geographical scope, this provision will become crucial in order to curb excessive extraterritorial effects, at least until the legitimacy of those effects has been judicially clarified. The analysis set out above clearly indicates that any such safeguarding provision must, at the very least, be interpreted broadly in order to minimise interference with public international law. It is indeed settled CJEU case law that provisions of secondary law must be interpreted, and their scope delimited, in conformity with binding international law as far as possible[119]; this reconciliatory interpretation must be given priority over other methods of interpretation.[120] In the light of the authors' prior conclusions, a relevant link between the economic substance of the transaction in issue and the territory of a participating Member State within the meaning of Article 4(3) of the Proposal should be excluded, for example, in cases of day-trading or high-frequency trading by financial institutions outside the participating Member States using foreign trading platforms. In a similar vein, transactions where the new shareholder (or the investor in other taxable securities) does not also become a stakeholder regarding the national economy of the Member State where the security was issued should also be excluded. It will certainly not be sufficient that the foreign transaction in issue has an impact on the balance sheet of a domestic company.[121]

> "Community legislation must be certain and its application foreseeable by those subject to it. That requirement of legal certainty must be observed all the more strictly in the case of rules liable to entail financial consequences."[122]

No lengthy explanations are needed to assert that Article 4(3) of the Proposal is not in conformity with this settled CJEU case law. It is manifestly inappropriate to refer to abstract concepts of international law where clear and directly relevant authorities and precedents are still in short supply. Moreover, in practice this approach entails the risk of very divergent implementation and application in the participating Member States. This, in turn, will provoke litigation and, ultimately, referrals to the CJEU for preliminary rulings. It will then be the CJEU rather than the Member States who will substantiate the territorial reach of taxation. The participating Member States can hardly have an interest in the CJEU having such an increased clout in the politically sensitive field of taxation. Therefore, the Council should not adopt this provision without further substantiation.

[119] See *Poulsen and Diva* (C-286/90), above fn.68, [1992] ECR I-6019 at [9]; *Air Transport Association of America*, above fn.69, [2012] 2 CMLR 4 at [123]; *Commission v Germany* (C-61/94) [1996] ECR I-3989 (European Court of Justice) at [52]; *Soysal* (C-228/06) [2009] ECR I-1031 (European Court of Justice) at [59], regarding international agreements.

[120] See AG Kokott's Opinion, *Intertanko* (C-308/06) [2007] ECR I-4057 (European Court of Justice) at [108].

[121] Which has however been put forward as an example in the Commission's "non-paper" on the territoriality of the tax, "Territoriality of the tax" (2012) (published online only), 3, accessible at: *http://ec.europa.eu/taxation_customs/taxation/other_taxes/financial_sector/index_en.htm* [Accessed March 26, 2013].

[122] Settled CJEU case law; see, e.g. *Halifax plc v Customs and Excise Commissioners* (C-255/02) [2006] ECR I-1609; [2006] STC 919 (European Court of Justice) at [72], with further references.

IV. Compatibility with the requirements of EU law

1. Fulfilling the EU Treaties conditions envisaged for the ECP

The ECP was introduced by the Treaty of Amsterdam 1997 (ToA) as a hybrid solution between the classical Community method and intergovernmental agreements.[123] It set procedural rules for establishing closer cooperation amongst subsets of Member States in the framework of EU law. The key principles of this "flexible" mode of integration are currently found in Article 20 of the Treaty on the European Union (TEU) and Articles 326 to 334 of the Treaty on the Functioning of the European Union (TFEU).[124] Although the adoption of acts under the ECP generally follows a standard legislative path (ordinary or special legislative procedure), it also has some particular features. Allowing cooperation in regional "clusters", the EU Treaties envisage a number of procedural and substantive safeguards aiming at securing the interests of the Internal Market and non-participating Member States.

The interpretation and practical application of these special provisions is far from clear. The ECP has so far been relied upon in two cases (in relation to divorce law in 2010 and patent protection in 2012), which makes the FTT Proposal one of the pioneers.[125] The EU act adopted in the context of enhanced cooperation has been challenged only once: Italy and Spain, which remained outside the harmonised framework in the area of unitary patent protection, brought actions against the authorisation decision of the Council and raised the question of its compliance with EU law.[126] The CJEU's judgment in this case should provide more clarity on the application of the procedural and substantive conditions that are stipulated in the EU Treaties. Some preliminary indications on the route that may eventually be taken by the CJEU can be found in the Opinion of AG Bot, published in December 2012, which will be discussed below.[127] At the moment, however, in the absence of the CJEU's guidance, the interpretation of the EU Treaty requirements is surrounded by uncertainty. Clarification is needed at two levels: first, how the conditions for the ECP should be justified at the stage of adoption (*ex ante* political control), and secondly, what is the standard of judicial review (*ex post* judicial control).

(a) Procedural conditions

According to Article 20 TEU, nine or more Member States can establish cooperation between themselves within the framework of the EU's non-exclusive competences (as defined in Article 3 TFEU), using EU institutional structures and applying the EU Treaties. The ECP can only be

[123] Consolidated version of the Treaty on European Union (TEU) [1997] OJ C340/145; Consolidated version of the Treaty establishing the European Community (TEC) [1997] OJ C340/173. See TEU Arts 43 to 45 and TEC Art.11.
[124] Consolidated version of the Treaty on European Union (TEU) [2012] OJ C326/13; Consolidated version of the Treaty on the Functioning of the European Union (TFEU) [2012] OJ C326/47.
[125] Based on the following authorisation decisions: (i) Council Decision of July 12, 2010 authorising enhanced cooperation in the area of the law applicable to divorce and legal separation [2010] OJ L189/12; (ii) Council Decision of March 10, 2011 authorising enhanced cooperation in the area of the creation of unitary patent protection [2011] OJ L76/53.
[126] *Kingdom of Spain and Italian Republic v Council of the European Union* (Joined Cases C-274/11 and C-295/11, pending) (*Spain and Italy v Council*).
[127] AG Opinion of December 11, 2012 in *Spain and Italy v Council* (Joined Cases C-274/11 and C-295/11, pending), above fn.126.

used as a "last resort" solution if an EU-wide agreement cannot be reached "within a reasonable time". The fulfilment of these conditions is verified at the stage of authorisation to proceed with the ECP, which is granted by the Council based on a proposal from the Commission and after obtaining the consent of the Parliament.[128] There is no dispute that the Proposal meets these conditions.

Procedural steps that follow the Council's authorising decision for establishing enhanced cooperation in the area of FTT replicate a special legislative procedure that is applicable to any harmonisation measure initiated under Article 113 TFEU. The national parliaments of EU Member States have eight weeks to submit comments on the Proposal. Next, the Parliament shall adopt an opinion: it may approve or reject the Proposal, as well as recommend some amendments. Although the Council may not bypass the Parliament, its opinion has an advisory nature only and does not create a legal obligation for the Council to follow it. The Economic and Social Committee will also be consulted. Finally and most crucially, the participating Member States shall reach a unanimous agreement in the Council. Article 333(2) TFEU contains a passerelle clause that allows the participating Member States, acting unanimously, to switch to the ordinary legislative procedure, which enhances the role of the Parliament. This, however, seems unlikely to happen in the case of the Proposal, despite a request made earlier by the Parliament.[129]

As the draft currently stands, the legislative process should be completed in the summer of 2013, since the transposition period for national legislators envisaged by Article 20 of the Proposal ends on September 30, 2013. The FTT should be introduced from January 1, 2014. This provisional timeframe, as well as other substantive provisions of the Proposal, can be amended before the FTT Directive is finally approved by the Council. Change may also occur in the geographical coverage: in the process of negotiations, some Member States may leave, as well as join the ECP.

(b) Substantive conditions

The compliance of the Proposal with the substantive conditions laid down by the EU Treaties leaves more room for discussion. The key role in this respect is played by Article 326(2) TFEU, which subjects any proposal under the ECP to the following conditions: it shall not (i) "undermine the internal market or economic, social and territorial cohesion", (ii) "constitute a barrier to or discrimination in trade between Member States" or "distort competition between them". The Commission's *travaux préparatoires* contain very little explanation of how these conditions are satisfied in the case of the FTT. The only document where this issue is discussed in any detail is an explanatory memorandum to the Commission Proposal for a Council Decision authorising enhanced cooperation.[130] The draft FTT Directive does not go beyond a traditional justification

[128] TFEU Art.329.

[129] European Parliament Legislative Resolution of December 12, 2012 on the proposal for a Council decision authorising enhanced cooperation in the area of the creation of financial transaction tax, para.2.

[130] Commission Proposal for a Council Decision authorising enhanced cooperation in the area of financial transaction tax, COM(2012) 631 final of October 25, 2012 (Proposal for a Council Authorisation Decision).

of compliance with the basic requirements for EU acts: the principles of conferral, subsidiarity and proportionality (Article 5 TEU),[131] and the IA contains only a brief statement that:

> "Harmonising a patchwork of different national taxes will not undermine the internal market. On the contrary, it will strengthen it by creating more coherence in the FTT jurisdiction and less administrative burden for business in EU11+ and beyond. Nor will this procedure undermine the single market or economic, social and territorial cohesion. Neither will it constitute a barrier to trade between Member States or distort competition between them".[132]

Although the requirements of Article 326(2) TFEU are closely linked and somewhat overlapping, not all of them have equal relevance and raise concerns in the context of the Proposal. For instance, the requirement that the ECP shall not "undermine … economic, social and territorial cohesion" appears to be largely satisfied. Article 174 TFEU (ex Article 158 TEC) can provide guidance for interpreting this condition, even if the Treaty of Lisbon excluded the explicit reference to Title XVIII of the TFEU ("Economic, Social and Territorial Cohesion") that was present in the previous version of this provision.[133] The notion of "economic, social and territorial cohesion" reflects the objective of the "harmonious development" of the EU, in particular by "reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions".[134] The Commission submits that "there are no indications" that the introduction of an FTT may cause "appreciable" differences in the economic development of participating and non-participating Member States, which would undermine these objectives.[135] Even if the Commission provides limited evidence in support of this conclusion, it would be equally hard to prove the opposite. Due to the diversity of the financial sectors in the participating Member States and those outside the FTT zone any estimates of potential macro-economic effects are sensitive to the underlying assumptions (e.g. the size of relocation).

Other conditions, however, should be discussed in greater detail as the justification for them provided by the Commission and their fulfilment by the Proposal are more questionable.

(i) **The ECP "shall not undermine the Internal Market".**

The Commission's reading of this condition is narrow. It considers that the Proposal contributes to the proper functioning of the Internal Market by reducing the risks of its fragmentation and *therefore* the state of the Internal Market "would be improved rather than undermined."[136] According to the IA, 11 Member States currently maintain some form of an FTT. This large number of co-existing tax regimes can be accepted as a sufficient justification for EU-wide harmonisation measures under Article 113 TFEU, but one can certainly question the extent to

[131] Proposal, above fn.1, and the accompanying explanatory memorandum.
[132] IA, above fn.4, 10.
[133] In the Nice-version of this provision, the enhanced cooperation should not "undermine … the economic and social cohesion established in accordance with Title XVII ['Economic and Social Cohesion'] of that Treaty [TEC]" (TEU Art.43(e)). See Consolidated versions of the Treaty on European Union and of the Treaty establishing the European Community [2002] OJ C325/1.
[134] TFEU Art.174. See also AG Opinion of December 11, 2012 in *Spain and Italy v Council* (Joined Cases C-274/11 and C-295/11, pending), above fn.126, at [150].
[135] Proposal for a Council Authorisation Decision, above fn.130, 7.
[136] Proposal for a Council Authorisation Decision, above fn.130, 7.

which the FTT adopted under the ECP eliminates market fragmentation. Amongst the participating Member States only three currently levy an FTT (Belgium, France and Greece), whilst the remaining eight countries with various forms of FTT (Cyprus, Finland, Ireland, Luxembourg, Malta, Poland and the UK) do not express an intention to join the harmonised zone. To strengthen the argument about creating a tool eliminating the fragmentation of financial markets, the Commission also refers to the levies "that are *likely* to be applied … if no harmonisation is undertaken."[137] Furthermore, it explains that other Member States can join the FTT zone at any other time in the future, which potentially expands the positive impact of the Proposal on the establishment of the Internal Market.

Indeed, the CJEU accepts that the Commission can exercise its legislative power in order to prevent the *emergence* of obstacles to the Internal Market "resulting from the divergent development of national laws" (so-called "preventive harmonisation").[138] Although the case law prudently suggests that "the emergence of such obstacles must be *likely* and the measure in question must be designed to prevent them",[139] it has not been rigorously observed. The CJEU has been very lenient in testing the "likelihood" and usually relies upon evidence provided by the EU legislature.[140] Furthermore, this line of case law has developed with reference to the application of Article 114 TFEU (which is associated with a risk that the EU legislature may exercise unlimited legislative competence that is subject to a qualified majority voting in the Council but produces approximation measures that have a binding effect for the EU-27). Even in these types of cases the CJEU rarely accepts that the limits of EU legislative competence have been breached. Considering that the ECP creates legally binding obligations only for participating Member States, the CJEU's willingness to police the limits of EU competence might be even lower.

Having said this, the authors of this article submit that the condition stipulated in Article 326 TFEU should be read as reaching beyond the narrow interpretation given by the Commission. The fact that EU intervention is necessary for the purposes of establishing the Internal Market should not substitute the question as to whether the chosen method (the ECP) is appropriate and such that would not *undermine* the Internal Market. This condition seems to emphasise another important aspect: the establishment of regional cooperation should not take the

[137] Proposal for a Council Authorisation Decision, above fn.130, 6 (emphasis added). The IA mentions that several participating Member States are in the process of introducing (Italy) or planning an FTT (Spain and Portugal). See IA, above fn.4, 61.
[138] *Vodafone* (C-58/08) [2010] ECR I-4999 (European Court of Justice) at [33]; *Germany v Parliament and Council* (C-380/03) [2006] ECR I-11573 (European Court of Justice) at [38] (and other case-law cited therein).
[139] See, above fn.138 (emphasis added).
[140] For instance, in *Spain v Council* (C-350/92) [1995] ECR I-1985 (European Court of Justice) at [33]–[36], the CJEU accepted the measure that was designed to prevent the "heterogeneous development of national laws" based on the Council's argument that divergent legal arrangements existed "in two Member States and were at the draft stage in another State". See also, S. Weatherill, "The Limits of Legislative Harmonization Ten Years after *Tobacco Advertising*: How the Court's Case Law has become a 'Drafting Guide'" (2011) 12 German Law Journal 827 and the cases discussed therein.

EU *further away* from the objective of creating "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured".[141] In this context, "undermine" opens the door to a relative assessment of the dynamic concept of an Internal Market: a situation as it stands before and after the measure in question was adopted. It is not enough to demonstrate that the Proposal contributes (or, more precisely, is *likely* to contribute) to the elimination of barriers between *some* Member States; in addition, it should not impede the free movement by creating disadvantages for financial transactions between the FTT zone and those countries that remain outside the ECP. As explained in Section II 2(a)(i) above, the Proposal may create a potential risk of double taxation at a much larger scale than it solves due to the interaction between the harmonised FTT zone and the independently designed FTTs introduced by the non-participating Member States. The Commission acknowledges the double taxation problem, but neither explores its scope in any detail, nor expresses its intention to initiate negotiations with the non-participating Member States in order to eliminate the potentially higher costs of cross-border transactions between the participating and non-participating Member States. It simply admits that the positive impact will not occur "immediately and fully" in the scale of 27 Member States and suggests that the non-participating Member States will benefit from the simplification of the regulatory environment and the introduction of a uniform regime in 11 jurisdictions.[142]

(ii) **The ECP "shall not constitute a barrier to or discrimination in trade between Member States nor distort competition between them".**

This condition frames the concern with the impact of enhanced cooperation on the Internal Market in terms of the traditional legal analysis as to whether the measure creates obstacles to the freedom of movement that are liable to hinder economic activity. In other words, it raises two questions: "Does the common system of FTT introduce a discriminatory tax treatment defined as treating differently situations which are identical or treating in the same way situations which are different?"[143] and "May it impede or render less attractive the exercise of the freedom of cross-border movement?"[144] The Commission argues that the tax "would apply

[141] TFEU Art.26(2).
[142] Proposal for a Council Authorisation Decision, above fn.130, 7.
[143] *Commission of the European Communities v France* (270/83) [1986] ECR 273 (European Court of Justice) at [18]; *Royal Bank of Scotland plc v Greece* (C-311/97) [1999] ECR I-2651; [2000] STC 733 (European Court of Justice) at [26].
[144] *Caixa Bank France v Ministere de l'Economie, des Finances et de l'Industrie* (C-442/02) [2004] ECR I-8961 (European Court of Justice) at [11]; *Columbus Container Services BVBA & Co v Finanzamt Bielefeld-Innenstadt* (C-298/05) [2007] ECR I-10451; [2008] STC 2554 (European Court of Justice) at [34]; *Finanzamt fur Korperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* (C-157/07) [2008] ECR I-8061; [2009] STC 138 (European Court of Justice) at [30]; *CIBA Speciality Chemicals Central and Eastern Europe Szolgaltato, Tanacsado es Keresdedelmi kft v Ado- es Penzugyi Ellenorzesi Hivatal (APEH) Hatosagi Foosztaly* (C-96/08) [2010] ECR I-2911; [2010] STC 1680 (European Court of Justice) at [19]; *National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond/Kantoor Rotterdam* (C-371/10) [2012] All ER (EC) 883; [2012] STC 114 (European Court of Justice) at [36].

consistently to all financial institutions and transactions concerned" and any differences in treatment are based on objective criteria.[145] Rejecting potential allegations under the classical discrimination approach, the Commission does not analyse the "obstacle"-based question as to whether the FTT may impede or render less attractive the exercise of the freedom of cross-border movement.

In relation to the distortion of competition, the Commission uses a familiar argument of *potential* risks: the ECP cannot be considered as distorting competition, since without this harmonising measure the distortion of competition through double taxation and double non-taxation would be much wider due to the uncoordinated introduction of national taxes on financial services.[146] As the IA further explains, the FTT will remove distortions of competition amongst participating Member States (other than those created by different national tax rates). However, one also ought to look at the Internal Market as a whole, keeping in mind that the national FTTs currently in place are much narrower than the proposed FTT and that the FTTs in the eight non-participating Member States will remain in place. It is not evident that the level of distortion will be less than is currently the case once the existing three (going up to six) narrow national FTTs are replaced with a much broader FTT in the eleven participating Member States.

The Commission takes the view that the "mere coexistence" of the FTT zone and national tax regimes "cannot as such be considered a barrier, discrimination or distortion of competition."[147] This interpretation at the very least disregards a distorting effect that may constitute an infringement of the fundamental freedoms; and it also neglects the problems that would not be caught under the fundamental freedom analysis, but might gain more weight in the context of Article 326(2) TFEU if the distortion of competition were to be considered as having an independent meaning. Two examples are provided here to illustrate the potential hindrances to the Internal Market.

First, although the CJEU has demonstrated its reluctance to find a non-discriminatory tax obstacle in breach of EU law, some cases indicate that this concern might go beyond a purely theoretical interest.[148] In *Sandoz GmbH v Finanzlandesdirektion für Wien, Niederösterreich und Burgenland*,[149] the CJEU examined the Austrian stamp duty levied under certain conditions on loan agreements contracted in Austria and other Member States. It agreed with AG Léger that the free movement of capital includes the right of EU citizens "to enjoy the most favourable conditions for investing their capital available to them in any

[145] Proposal for a Council Authorisation Decision, above fn.130, 8.
[146] Proposal for a Council Authorisation Decision, above fn.130, 8.
[147] Proposal for a Council Authorisation Decision, above fn.130, 8.
[148] *Sandoz GmbH v Finanzlandesdirektion für Wien, Niederösterreich und Burgenland* (C-439/97) (*Sandoz*) [1999] ECR I-7041 (European Court of Justice); for further analysis, see, for instance, K. Banks, "The Application of the Fundamental Freedoms to Member State Tax Measures: Guarding against Protectionism or Second-guessing National Policy Choices?" (2008) 33 ELR 482; S. Douma, "Non-discriminatory tax obstacles" (2012) 21 EC Tax Review 67.
[149] *Sandoz* (C-439/97), above fn.148, [1999] ECR I-7041.

of the States which make up the Community."[150] Therefore, depriving residents of "the possibility of benefiting from the absence of taxation which may be associated with loans obtained outside the national territory" constitutes an obstacle precluded by the Treaty.[151] This case provides potential arguments for challenging elements of the Proposal, such as the issuance principle. The Austrian provision in question was, however, justified by virtue of the derogation envisaged by Article 65 TFEU to prevent infringements of national tax law and regulations.[152] As discussed in Section II 1(b)(iii), the issuance principle was introduced to enhance protection against tax avoidance and, in particular, to discourage the potential relocation of financial institutions and activities.[153] It is questionable whether the issuance principle can be accepted by the CJEU as a proportionate measure for reaching this objective. It also appears somewhat surprising that the Commission invokes anti-avoidance concerns to defend measures against relocation of business activities to non-participating Member States, even though both the CJEU's case law and the Commission insist that relocations that seek to benefit from more attractive tax regimes in another EU Member State do not constitute avoidance.[154]

Secondly, from the perspective of a financial institution established in a participating Member State, financial transactions with an entity or individual established in a non-participating Member State would be treated less favourably than if the same transaction were carried out by an institution established in the non-participating Member State. Similarly, for financial institutions located in a non-participating Member State, the issuance principle makes the acquisition of shares (as well as bonds and other financial instruments) in a company established in a non-participating Member State more attractive than the acquisition of a similar instrument issued by a company established in a participating Member State. The FTT may thus put a German bank at a competitive disadvantage vis-à-vis UK banks in relation to UK customers (amongst others) and distort competition for investments. This certainly does not contribute to the EU's objective of creating a level playing field for businesses. Admittedly, any kind of "flexible" cooperation creates a potential difference between legal regimes both inside and outside, and thus some degree of distortion. The CJEU would therefore have to decide which test should be used in the context of the ECP and which defences may be relied upon by the EU legislator to justify the measure in question.

[150] AG Opinion in *Sandoz* (C-439/97), above fn.148, [1999] ECR I-7041 at [47].
[151] *Sandoz* (C-439/97), above fn.148, [1999] ECR I-7041 at [19]–[20].
[152] *Sandoz* (C-439/97), above fn.148, [1999] ECR I-7041 at [24].
[153] Proposal, above fn.1, and the accompanying explanatory memorandum.
[154] See, e.g. *Cadbury Schweppes plc v Inland Revenue Commissioners* (C-196/04) [2006] ECR I-7995; [2006] STC 1908 (European Court of Justice) at [36]–[37]; endorsed by the Commission in its Communication on the application of anti-abuse measures in the area of direct taxation of December 10, 2007, COM(2007) 785 final, at point 2: "The ECJ has also expressly confirmed that it is quite legitimate for tax considerations to play a role in the decision on where to establish a subsidiary."

Despite the formalistic justification given by the Commission, the UK Financial Secretary to the Treasury in a letter dated December 16, 2012 addressed to the European Scrutiny Committee of the House of Commons stated that the UK Government "remains to be convinced that the Commission has adequately considered whether the proposal is consistent with relevant TFEU Articles [Articles 326 and 327 TFEU]."[155] At the January ECOFIN Council meeting, the UK Government, however, noted that the Commission did not provide a comprehensive impact assessment of enhanced cooperation on individual Member States (both participating and non-participating), and that the fulfilment of the conditions set by the EU Treaties "was not possible" to verify.[156] Following the publication of the Proposal, the UK Government took this concern even further by questioning the compliance of this measure with EU law.[157] This requires a more careful examination of the question whether and to what extent non-participating Member States can actually oppose the act considered under the ECP.

2. Respecting the competences, rights and obligations of non-participating Member States

As Weatherill rightly notes, due to "the evolved patterns of mutual interdependence among the Member States", it becomes "implausible that closer co-operation between some will not affect the others to some extent."[158]

However, Member States that do not wish to participate in the ECP have limited ability to oppose it given that the authorisation of the ECP is subject to a *qualified majority* voting by the Council. In the context of the FTT, the UK, as well as the Czech Republic, Luxembourg and Malta, abstained. At the stage of adoption, "all members of the Council may participate in its deliberations" but only the representatives of the participating Member States may take part in voting.[159] The participating Member States thus can proceed with the act even if its content does not satisfy the interests of non-participating Member States. Moreover, Article 327 TFEU provides that the non-participating Member States "shall not impede its implementation by the participating Member States." This obligation is further enhanced by the principle of sincere cooperation envisaged by Article 4(3) TEU.

The criticism of the limited ability of the non-participating Member States to influence the process of enhanced cooperation should be weighed against the role that is attributed to this procedure by the EU Treaties. The ECP was introduced in response to demands for more "flexibility" in the enlarged EU. The Amsterdam version of the ECP, due to its restrictive conditions, was considered to be "disappointingly minimalist"[160] and it was not used. The Treaty

[155] House of Commons. European Scrutiny Committee of the House of Commons, *26th Report of Session 2012–13: "Enhanced Cooperation and a Financial Transaction Tax (34372)"* HC Paper No.86-xxvi (Session 2012/13), 37.
[156] House of Commons. European Scrutiny Committee of the House of Commons, *34th Report of Session 2012–13: "Enhanced Cooperation and a Financial Transaction Tax (34372)"* HC Paper No.86-xxxiv (Session 2012/13), 4–5.
[157] House of Commons. European Scrutiny Committee of the House of Commons, *38th Report of Session 2012–13: "Enhanced Cooperation and a Financial Transaction Tax (33179, 34372, 34692)"* HC Paper No.86-xxxvii (Session 2012/13), 10–11.
[158] S. Weatherill, "If I'd Wanted You to Understand I Would Have Explained it Better: What is the Purpose of the Provisions on Closer Co-operation Introduced by the Treaty of Amsterdam?" in D. O'Keeffe and P. Twomey (eds), *Legal Issues of the Amsterdam Treaty* (Oxford: Hart Publishing, 1999), 21, 27.
[159] TEU Art.20(3) and TFEU Art.330.
[160] E. Philippart and G. Edwards, "The Provisions on Closer Co-operation in the Treaty of Amsterdam: the Politics of Flexibility in the European Union" (1999) 37 JCMS 87, 88–89 (and other sources cited).

changes made by the Treaty of Nice 2001 (ToN) and then by the Treaty of Lisbon 2007 (ToL) deliberately simplified its application to make it more "workable".

First, the participatory rules were much stricter, requiring "at least a majority of Member States" to get involved (ex Article 43(1)(d) TEU, ToA).[161] The majoritarian principle was substituted by a fixed threshold of "a minimum of eight Member States" for EU-15 (ex Article 43(g) TEU, ToN) and subsequently by "at least nine Member States" for EU-27 (Article 20 TEU, ToL).[162] The FTT Proposal is supported by 11 participating countries, which is the lowest figure in the short history of the ECP. The problem with the protection of interests of non-participating Member States has already emerged in the context of unitary patent protection. In the case of FTT, it may potentially be even wider: at the moment, a number of Member States with important financial centres are not participating.

Secondly, the initial condition, that the enhanced cooperation should not "*affect* the competences, rights, obligations and *interests* of those Member States which do not participate" (ex Article 43(1)(f) TEU, ToA) was substituted by the much softer need to "*respect* the competences, rights and obligations of those Member States which do not participate" (ex Article 43(h) TEU, ToN; Article 327 TFEU, ToL).[163] As explained in Section II 2(a)(i) above, the introduction of the FTT may lead to double taxation due to the existence of conflicting national tax measures in non-participating Member States. Does the fact that the FTT may influence the way in which some of the non-participating Member States exercise their taxing rights and may have a considerable impact on their financial markets amount to a lack of "respect" for their competences? It was certainly much easier to prove that the ECP would "affect" the "interests" of non-participating Member States.

Finally, under the provisions of the ToA, any Member States could oppose the authorisation decision of the Council "for important and stated reasons of national policy" (ex Article 11 TEC).[164] In this case, the veto could only be overcome by the unanimous decision of the European Council. The referral of the issue to the European Council, however, had to be supported by a qualified majority in the Council. The ToN repealed this provision, limiting the possibility of individual Member States to oppose the proposal under the ECP. This step was balanced by the increasing role of the Parliament.[165]

This brief analysis demonstrates that non-participating Member States have a limited ability to influence the course of enhanced cooperation. Indeed, the interests of non-participating Member States may be seen to be protected through the Council's authorisation decision that requires a qualified majority voting. However, as seen in Section II, the analysis of the impact on non-participating Member States can be limited and, furthermore, important changes to the proposed measure can be made after this vote is taken. In light of these arguments, it would be reasonable to criticise the procedural framework laid down by the EU Treaties. However, one ought to remember that the liberalisation of the procedural requirements was intentional. Therefore, perhaps, the way to balance the interests of the participating and non-participating

[161] ToA, above fn.123.
[162] ToN, above fn.133; ToL, above fn.124.
[163] ToA, above fn.123; ToN, above fn.133; ToL, above fn.124.
[164] ToA, above fn.123.
[165] See TEC Art.11(2), ToN, above fn.133; TFEU Art.329(1), ToL, above fn.124.

Member States should be sought elsewhere. Potentially, the CJEU could step in. So, what are the possibilities of challenging the FTT?

3. Judicial review of the ECP

The ECP can be challenged in the CJEU at two main stages: actions can be brought against the Council's authorisation decision and against a subsequently adopted legislative measure. In both cases, EU Member States as "privileged applicants" can initiate a procedure under Article 263 TFEU, which stipulates that such actions should be based on the following grounds: a lack of competence, infringement of essential procedural requirements, the EU Treaties or any rule of law relating to their application, and misuse of powers by EU institutions. Legal and natural persons, however, have limited rights under Article 263(4) TFEU: they can initiate proceedings only if the standing requirements of "direct and individual concern to them" are satisfied.[166] In view of the restrictive interpretation of these conditions by the CJEU, it is unlikely in the context of FTT. Furthermore, the proceeding that challenges the validity of an EU act under this provision should be initiated within two months of its publication (Article 263(6) TFEU).

A more feasible way for interested legal and natural persons to challenge the validity of the FTT is provided by the preliminary ruling procedure (Article 267 TFEU). According to the settled case-law

> "any party has the right, in proceedings before the national courts, to plead, before the court hearing the case, the invalidity of an act of the Union and to ask that court, which has no jurisdiction itself to declare the act invalid, to put that question to the Court by means of a reference for a preliminary ruling."[167]

The time-limit of two months would not apply to this plea and will be determined by national procedural rules.[168]

As any other EU act, the FTT Directive should comply with the Treaties and EU law (Article 326(1) TFEU) and thus could be challenged on various grounds. Amongst others, it should respect the limits of legislative competence set by the principles of conferral, subsidiarity and proportionality (Article 5 TEU), other general principles of EU law (e.g. legal certainty) and, as discussed in Section III above, customary international law. It should comply with the directly effective provisions of the Treaties and secondary EU legislation: in this context, the free

[166] For the basic test see *Plaumann & Co v Commission of the European Economic Community* (25/62) [1963] ECR 95 (European Court of Justice), in order to establish "individual concern" a natural or legal person should demonstrate that by "certain attributes which are peculiar to them or by reason of circumstances in which they are differentiated from all other persons and by virtue of these factors distinguishes them individually just as in the case of the person addressed." The most recent discussion on this question can be found in the Opinion of AG Kokott of January 17, 2013 in *Inuit Tapiriit Kanatami and Others v European Parliament and Council of the European Union* (C-583/11 P, pending). The AG argues that the restrictive *Plaumann* case law should be retained, at [89].

[167] *Thomas Pringle v Government of Ireland, Ireland and The Attorney General* (C-370/12) (*Pringle*) [2013] All ER (EC) 1 (European Court of Justice) at [39]; see also *Nachi Europe GmbH v Hauptzollamt Krefeld* (C-239/99) [2001] ECR I-1197 at [35]; *Unión de Pequeños Agricultores v Council* (C-50/00 P) [2002] ECR I-6677 (European Court of Justice) at [40]; *Criminal proceedings against E and F* (C-550/09) [2010] ECR I-6213 (European Court of Justice) at [45].

[168] Because financial operators can hardly be seen as a party which "beyond doubt had standing" under TFEU Art.263(4) (see *Pringle* (C-370/12), above fn.167, [2013] All ER (EC) 1 at [41] and the case law cited).

movement of capital, on the one hand, and the Capital Duty Directive, on the other hand, would be the first point of reference.[169]

Leaving aside these traditional grounds, the authors question here whether the special procedural and substantive requirements that are envisaged by the EU Treaties in the context of the ECP create any additional safeguards.[170] As discussed above, the scope of judicial review in relation to this category is unclear, in particular in relation to the key substantive criteria stipulated by Article 326 TFEU. The CJEU's judgment in *Kingdom of Spain v Council of the European Union and Italian Republic v Council of the European Union*, where Spain and Italy contested the Council decision that authorised enhanced cooperation for the establishment of unitary patent protection, should bring more clarity.[171] As AG Bot rightly pointed out in his Opinion of December 11, 2012, "the Court will have to define the parameters of the review of compliance with the conditions of authorisation".[172] However, if the CJEU follows the approach proposed by the Advocate General, the review of substantive conditions stipulated by the Treaty will be of a very limited nature. At point 27 of his Opinion, AG Bot refers to the Opinion of AG Jacobs in *SAM Schiffahrt and Stapf*:

> "[I]t is important to bear in mind the limits of the Court's power to review legislative measures adopted by the Council. Those limits arise from the fundamental principle of the separation of powers within the Communities. Where the Treaty has conferred wide legislative powers on the Council, it is not for the Court to substitute its own assessment of the economic situation or of the necessity or suitability of the measures adopted for those of the Council. By doing so it would usurp the legislative role of the Council by imposing its own views of the economic policies to be pursued by the Communities."[173]

Accordingly, AG Bot goes on to suggest that the assessment of whether the conditions envisaged by Article 326 TFEU are satisfied should be limited to the consideration of

> "whether, in the exercise of that freedom of choice [on the nature and scope of the measures], the EU legislature has made a manifest error or misused its powers or has manifestly exceeded the bounds of its discretion".[174]

This test corresponds to an approach taken by the CJEU in accessing the limits of EU legislative competence in light of Article 5(4) TEU (proportionality).[175] The CJEU recognises a broad discretion for EU legislators in situations involving a variety of political, economic and social choices and where the choice of policy option is subject to "complex assessments and

[169] Under the Proposal, the Capital Duty Directive remains fully applicable—see Proposal, above fn.1, and the accompanying explanatory memorandum.
[170] Most importantly, TEU Art.20 and TFEU Arts 326–327.
[171] *Spain and Italy v Council* (Joined Cases C-274/11 and C-295/11, pending), above fn.126.
[172] AG Opinion of December 11, 2012 in *Spain and Italy v Council* (Joined Cases C-274/11 and C-295/11, pending), above fn.126, at [26].
[173] AG Opinion of February 27, 1997 in *SAM Schiffahrt and Stapf* (Joined Cases C-248/95 and C-249/95) [1997] ECR I-4475 at [23].
[174] AG Opinion of December 11, 2012 in *Spain and Italy v Council* (Joined Cases C-274/11 and C-295/11, pending), above fn.126, at [29].
[175] *Norbrook Laboratories* (C-127/95) [1998] ECR I-1531 (European Court of Justice) at [89]–[90]; see also *Vodafone* (C-58/08), above fn.138, [2010] ECR I-4999 at [52] (and other case law cited).

evaluations".[176] The question of illegality is limited to an assessment of whether "the measure is manifestly inappropriate having regard to the objective which the competent institution is seeking to pursue".[177] The appropriateness is assessed by reference to criteria used by the legislature, which must be objective in nature and as such may justify even substantial negative economic consequences of the measure.[178]

AG Bot acknowledges the difference between the judicial review of the authorisation decision and the EU acts subsequently adopted under the ECP.[179] Accordingly, the former is associated with the choice of procedural framework, whilst the latter reflects the "concrete effect" of enhanced cooperation.[180] One can only speculate on the extent to which the approach proposed for the judicial review of the Council's authorisation decision would differ from the review of EU acts subsequently adopted under the ECP.

The Opinion of AG Bot shows that despite a restrictive formulation of procedural and substantive conditions for the ECP in the EU Treaties, the CJEU may well apply a very narrow standard of review. This would not be the first example of the CJEU's resistance to becoming an arbiter in a political arena: a similar approach has recently been demonstrated in the *Thomas Pringle v Government of Ireland, Ireland and The Attorney General* judgment on a stability mechanism for Member States in the Eurozone.[181] This cautious position could be explained if viewed in the context of the political purpose served by the ECP. If the Treaty conditions are to be interpreted and applied strictly, the ECP may remain a hypothetical possibility that is hardly ever used. In this case, Member States would have to look for other possibilities, potentially beyond the framework of EU law but involving cooperation at intergovernmental level: something that the ToA aimed to address by introducing the ECP.[182] The question, however, remains open as to whether the CJEU's approach should be shaped by these political considerations.

A right balance is thus still to be found: if narrow parameters of judicial review are applied by the CJEU, the mechanisms of political control should be strengthened. This would imply a more detailed assessment by the Commission of the conditions for enhanced cooperation, as well as a more comprehensive analysis of the potential impact on non-participating Member States than that provided in the case of the FTT so as to allow the Council to make an informed decision. Unless the political process is improved, Member States might react to a limited ability

[176] To that effect see, e.g. *Vodafone* (C-58/08), above fn.138, [2010] ECR I-4999 at [52]; *Jippes v Minister van Landbouw, Natuurbeheer en Visserij* (C-189/01) [2001] ECR I-5689 (European Court of Justice) at [82]–[83]; *British American Tobacco (Investments) and Imperial Tobacco* (C-491/01) [2002] ECR I-11453 (European Court of Justice) at [123]; *Alliance for Natural Health and Others* (C-154/04) [2005] ECR I-6451 (European Court of Justice) at [52]; *S.P.C.M. and Others* (C-558/07) [2009] ECR I-5783 (European Court of Justice) at [42].

[177] See above fn.176.

[178] To that effect see, e.g. *Vodafone* (C-58/08), above fn.138 [2010] ECR I-4999 at [53]; *Tempelman and van Schaijk* (Joined Cases C-96/03 and C-97/03) [2005] ECR I-1895 (European Court of Justice) at [48]; *Greece v Commission* (C-86/03) [2005] ECR I-10979 at [96]; *Agrarproduktion Staebelow* (C-504/04) [2006] ECR I-679 (European Court of Justice) at [37].

[179] AG Opinion of December 11, 2012, in *Spain and Italy v Council* (Joined Cases C-274/11 and C-295/11, pending), above fn.126, at [137].

[180] AG Opinion of December 11, 2012, in *Spain and Italy v Council* (Joined Cases C-274/11 and C-295/11, pending), above fn.126, at [137].

[181] *Pringle* (C-370/12), above fn.167, [2013] All ER (EC) 1.

[182] D.T. Murphy, "Closer or Enhanced Cooperation: Amsterdam or Nice" (2003) 31 Ga. J. Int'l & Comp. L. 265, 305–308. To that point see also *Pringle* (C-370/12), above fn.167, [2013] All ER (EC) 1 at [169].

to challenge a legislative act adopted under the ECP once permission to use the procedure is granted, by voting against the ECP as a precaution. Another concern must be kept in mind in this context. According to Article 328(2) TFEU, the Commission is under an obligation to inform the Parliament and the Council on a regular basis regarding developments in enhanced cooperation. The Proposal envisages that the report on its application, and if appropriate a proposal for review, shall be issued every five years. Any changes will require a unanimous vote by the participating Member States: individual participating Member States may not opt out once the Proposal has been adopted in Council and, furthermore, one vote is sufficient to stop a "collective" exit. This inflexibility again calls for a stricter scrutiny of the negative effects on the Internal Market.

IV. Conclusion

The FTT debate will rage on. Indeed, the closer we get to the adoption of the tax, the louder some voices will get. This article has sought to provide a dispassionate examination of some of the questions that have arisen out of the recent Proposal for the adoption of the FTT under enhanced cooperation.

The Proposal introduces several changes as compared to the earlier version of 2011, but some critical issues remain unaddressed. For instance, the Commission has maintained its position on the desirability of creating disincentives for high frequency trading through an FTT, even though it is still unclear whether such trading has a negative impact on equity markets. Other serious issues that still lack a convincing solution are tax cascading and the increased risk of double taxation within the Internal Market. There is also no comprehensive and transparent consideration of the positive and negative effects of this partial harmonisation for the financial sector and the economies of non-participating Member States.

In the field of anti-avoidance, one of the most striking amendments consists in the addition of a very detailed GAAR to the Proposal, which appears to be broader than those found in previous tax directives. However, not all of the abuse criteria suggested by the Proposal are fully coherent. Another anti-avoidance measure is the new geographical scope of the tax: formerly based on the "residence principle" and the "place of transaction principle", the Proposal now adds the "issuance principle." While this extension of territorial reach might curb some of the apprehended relocation effects of the FTT, it also implies far-reaching extraterritorial effects that are potentially in conflict with customary international law. In particular, doubts exist with respect to the compatibility of the "contagion effect" and the issuance principle with the internationally recognised territoriality principle. The Proposal also raises a number of legal questions concerning the satisfaction of the general requirements imposed by the EU Treaties on the use of the ECP.

Notwithstanding these legal concerns, the practical possibility of challenging the FTT and the certainty of outcome in both cases is unclear. Given the considerable impact that the FTT Directive will have, one can expect that the CJEU will be given an opportunity to express its opinion on the FTT and to clarify the parameters of judicial review for actions undertaken under

the ECP. This will define not only the prospects of the FTT, but also the future use of this procedure in the context of tax policy-making in the EU. ☞

☞ Enhanced co-operation; EU law; Extraterritoriality; Financial transactions tax; International law

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