Submission on the Zero-Ten Proposals

Preamble

The revised zero-ten proposals presented to the public on 5th May 2006 are significantly improved over previous incarnations of the plans and indeed the following statements must now be considered to have been made prematurely:

- *"You will know that we have now successfully concluded this process"* (Senator Walker, JEP Finance Review, April 2005)

(http://www.thisisjersey.com/finance2005/showfir.pl?ArticleID=000001)

- '*my Committee has ensured that its proposals comply'* (Senator Le Sueur, 6th July 2005)

(From written questions to the States of Jersey 25th July, 2005)

I remain concerned that the proposals still include within their body possible grounds for finding Jersey to be in breach of the EU Code of Conduct on Business Taxation.

I am of the opinion that the leveling of the playing field between resident and non-resident trading companies, irrespective of international considerations is to the future benefit of Jersey's economy in maintaining capital within the jurisdiction of Jersey.

I am of the opinion that the European Commission, if not the UK or ECOFIN will be reviewing our plans with a view to finding a breach rather than compliance.

Indeed the European Commission would seem unlikely to accept anything short of full implementation of the taxation regime pre-dominant in the United Kingdom.

Summary

- Non-compliance with the EU Code of Conduct on Business Taxation in preferential treatment of non-resident investment companies compared to resident investment companies.
- The questionable economic wisdom of a 'look through' provision on Jersey resident investment companies owned by Jersey residents.
- 'Deferred distribution' of 100% of profits does not take account of the usual economic activity of using profits to fund future growth. If a charge is made it should be levied on a more realistic basis and assume a 'normal' dividend level of 40% of profits.
- RUDL needs further examination once further details are released.
- Utilities (or Monopolies) Tax could be levied at a higher rate.
- Approval by the UK and ECOFIN is not the end of this process.
- The Finance Industry is granted 'favoured political status' which is damaging to the Island's economy.
- We should support, but not subsidize the finance industry.
- The GST exemption to the financial services must be curtailed.

1.0 What is the EU Code of Conduct on business taxation?

The Code of Conduct (which was developed by a group chaired by Ms. Primarolo) is set out in a report that was published in November 1999 that defines 'harmful' tax measures as being those that:

> "*provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code.*
>
> *Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any other relevant factor.*
>
> *When assessing whether such measures are harmful, account should be taken of, inter alia:*
>
> 1. *whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or*
> 2. *whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base, or*
> 3. *whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages, or..*"

The Code of Conduct includes a commitment by EU member states not to introduce new tax measures that are 'harmful' (a 'standstill' commitment); and to remove existing 'harmful' tax measures (a 'rollback' commitment).

Whilst the Code of Conduct is not an EU directive, but rather an agreement between EU member states, it is expected that member states will (provided that the tax package as a whole is adopted) seek to work within its

terms. The Code of Conduct will commit member states to promoting its principles in other countries outside the EU; in particular, the Code of Conduct provides that:

> "*Member States with dependent or associated territories or which have special responsibilities or taxation prerogatives in respect of other territories commit themselves within the framework of their constitutional arrangements, to ensuring that these principles are applied in those territories.*"

(Source: http://www.volaw.com/pg319.htm)

Mr Richard Teather in his published work states that this is

> *"a voluntary process with no enforcement powers, and it is a political process with no objective judicial arm to decide what practices constitute harmful tax competition."*

http://www.iea.org.uk/files/upld-publication303pdf?.pdf

This may be considered somewhat misleading, Jersey is fundamentally economically dependent on the EU and the UK and as such is unable to counter a strong suggestion from the British government.

Any member of the EU may request details of the package and insist that the United Kingdom enforce compliance.

The European Court of Justice is currently considering issues with regard to Gibraltar and particularly if the 'regional selectivity' case is upheld then Jersey will have little choice but to follow suit.

2.0 The 'look-through' provision on Investment Companies

From the 'The Zero/Ten Proposal'

> 23.1.2 Under the zero/ten system a resident company taxed at the 0% rate is on all fours with an offshore company and so it may be considered natural for the zero/ten system to apply look through as a default, with or without a motive override.
>
> 23.1.3 However this may be open to challenge on a number of fronts as follows:
> - The funding considerations for shareholders who are being taxed on the income of a third party which may lead to a distribution policy which results in unwanted tax liabilities for non-Island resident shareholders in their territory of residence
> - it is potentially inequitable
> - it is difficult to manage de minimis considerations
> - there are Jersey company law implications if the company is treated as being an agent for the shareholder and implications for the veil of incorporation since, if the company is acting as an agent for the shareholder, the shareholder may become responsible as principal for the company's actions
> - there are human rights implications of taxing a minority shareholder on the income of an independent third party over whom he has no effective control
> - the high level of disclosure required and the computational complications coupled with timing issues for companies whose period of account is not simultaneous with the Island's tax year
> - the identification of interests where shareholdings are held through other companies or trusts or by connected persons
> - the treatment of losses between different companies
> - the differential treatment of dividends between those paid by look through companies and those taxed at the 10% rate
> - the Code implications.

If these considerations were considered to be good cause not to apply the 'look-through' provision to trading companies, then I can not see why a look through provision should be applied to investment companies.

As the 'look through' provision has now been accepted as a breach of the code there is no basis for expectation that should it not constitute a breach if solely applied to investment companies.

No independent research on the legal implications outlined above has been undertaken.

However, assuming that the 'look through' provision contravenes in certain circumstances both the European Convention of Human Rights and Company Law this proposal is unworkable.

3.0 Mechanisms to avoid the 'look-through' provision of Jersey Investment Companies owned by Jersey residents.

I can see no reason why a Jersey resident would not simply wind up his Jersey company and re-establish a company in an alternate jurisdiction. There are no rules preventing or discouraging through taxation removing capital from Jersey in favour of an alternate jurisdiction.

Should this alternate jurisdiction similarly levy a charge of 0% tax, as will be the case in Guernsey, then market forces will lead to Jersey resident capital flight from Jersey to other comparatively 'low-tax' jurisdictions.

Jersey will of course be entitled to claim taxation on any dividends received by the resident.

In light of this, I can see no good reason not to simply allow Jersey residents to maintain investment companies with the jurisdiction an not apply the 'look-through' provision.

4.0 Deemed distribution after three years

From the 'The Zero/Ten Proposal'

> 24.3.3 Given that the regular payment of dividends is part of the normal economic cycle of a trading company, it is proposed to introduce a deemed distribution charge for the Island resident shareholders of companies subject to the standard rate of corporate income tax.

Whilst it is usual for a company to pay dividends as part of the normal economic cycle, it is not usual for a company to distribute 100% of its trading profit.

Reserves are built up in order for example to fund capital investment, corporate actions, diversification or the establishment of additional retail centres, measures which contribute towards future economic growth.

For example, taking a typical FTSE 100 company, the Royal Bank of Scotland Plc, the usual ratio of dividend to profit is typically in the region of 40%. (See Appendix One, Correspondances)

In order to maintain the competitiveness of Jersey businesses this reinvestment of profit should be recognised and accounted for within any 'deemed distribution' scheme.

5.0 RUDL Fee

Whilst the exact nature of this proposal is not revealed, I have made the following assumptions, based on similar taxes levied in Gibraltar and Bermuda:

- Directors, partners or sole traders themselves will not count towards the headcount
- That the charge will only be made in respect of employees within the jurisdiction of Jersey and not elsewhere (as this is beyond the scope of the Regulation of Undertakings Law)
- Whilst the 'median' charge will be applied to most businesses tourism and agriculture will be subject to a lower rate
- Utilities and public companies (not subject to deferred distribution) will be subject to a higher rate.

There is an economic benefit to taxing the use of scarce resources and labour is undoubtedly to be considered a scarce resource in Jersey to do so on the basis of a headcount rather than on a payroll basis makes this a very regressive form of taxation.

The imposition of a higher on monopolies (i.e. those identified as the companies liable to pay 20% tax with no deferred distribution), would also make economic sense to discourage these companies from utilizing excess labour.

To remove the finance industry from the scope of this tax similarly does little to discourage economic diversification. This again must be a questionable move as it simply reinforces the 'politically-favoured' status that the Government may be seen to apply to the finance industry.

6.0 Utilities Tax

The institution of a 'monopoly tax' on the large utility companies, many of whom make supra-normal profits is to be welcomed. As this was a policy of the Centre Party I cannot fault this other than to suggest that the rate of tax on these companies might be raised.

7.0 The relationship with the EU

Whilst it is usual for Jersey to claim non-membership of the EU, there is an alternate argument which is popular in Europe that Jersey is a part of the European Union because Article 227(4) of the Treaty of Rome applies the Treaty and Community measures to any European territory for whose external affairs a Member State is responsible.

That under Article 227 (5)(c)

This Treaty shall apply to the Channel Islands and the Isle of Man only to the extent necessary to ensure the implementation of the arrangements for those islands set out in the Treaty concerning the accession of new

Member States to the European Economic Community and to the European Atomic Energy Community signed on 22 January 1972."

Which refers to:

Protocol 3 to the Act of Accession

Article 1

The Community rules on customs matters and quantitative restrictions, in particular those of the Act of Accession, shall apply to the Channel Islands and the Isle of Man under the same conditions as they apply to the United Kingdom. In particular, customs duties and charges having equivalent effect between those territories and the Community, as originally constituted and between those territories and the new Member States, shall be progressively reduced in accordance with the timetable laid down in Articles 32 and 36 of the Act of Accession.

The Common Customs Tariff and the ECSC unified tariff shall be progressively applied in accordance with the timetable laid down in Articles 39 and 59 of the Act of Accession, and account being taken of Articles 109, 110 and 119 of that Act. 2. In respect of agricultural products and products processed there from which are the subject of a special trade regime, the levies and other import measures laid down in Community rules and applicable by the United Kingdom shall be applied to third countries. Such provisions of Community rules, in particular those of the Act of Accession, as are necessary to allow free movement and observance of normal conditions of competition in trade in these products shall also be applicable.

The Council, acting by a qualified majority on a proposal from the Commission, shall determine the conditions under which the provisions referred to in the preceding sub-paragraphs shall be applicable to these territories.

Article 2

The rights enjoyed by Channel Islanders or Manxmen in the United Kingdom shall not be affected by the Act of Accession. However, such persons shall not benefit from Community provisions relating to the free movement of persons and services.

Article 3

The provision of the Euratom Treaty applicable to persons or undertakings within the meaning of Article 196 of that Treaty shall apply to those persons or undertakings when they are established in the aforementioned territories.

Article 4

The authorities of these territories shall apply the same treatment to all natural and legal persons of the Community.

Article 5

If, during the application of the arrangements defined in this Protocol, difficulties appear on either side in relations between the Community and these territories, the Commission shall without delay propose to the Council such safeguard measures as it believes necessary, specifying their terms and conditions of application. The Council shall act by a qualified majority within one month.

Article 6

In this Protocol, Channel Islander or Manxman shall mean any citizen of the United Kingdom and Colonies who holds that citizenship by virtue of the fact that he, a parent or grandparent was born, adopted, naturalised or registered in the Island in question; but such a person shall not for this purpose

be regarded as a Channel Islander or Manxman if he, a parent or a grandparent was born, adopted or naturalised or registered in the United Kingdom. Nor shall he be so regarded if he has at any time been ordinarily resident in the United Kingdom for five years. The administrative arrangements necessary to identify these persons will be notified to the Commission.

http://www.isleofman.com/finance/why_iom/intro_over/cons_parl_gov.htm

It is clear that the nature of the relationship between Jersey and the EU ultimately lies out of our hands should the United Kingdom not wish to use it's national veto to overturn a motion revising the above protocol then the requirement to enact all EU legislation can readily be enforced upon us even against our will.

However, it is subsequently possible to withdraw from the EU as was done by Greenland on achieving its independence from Denmark. Such a move would first require negotiation of independence from the United Kingdom.

8.0 Gibraltar, the Code of Conduct on Business Taxation and the EU

8.1 Initial Measures adopted by Gibraltar

The main elements of the new company taxation system, that will apply to all companies in Gibraltar, whether local or international, whether doing business locally or abroad, are as follows:-

1. Company profits tax will be nil. Tax exempt status and tax qualifying status will be abolished.

2. A new "Company Payroll Tax" (similar to what exists in Bermuda and elsewhere) will be introduced in respect of employees in Gibraltar. This will be charged at a sum per annum per employee. This payroll tax is a tax on the company and is payable by the company only.

3. A new Business Property Occupation Tax will be introduced in respect of property occupied in Gibraltar by companies for business purposes.

4. The Payroll Tax and the Business Property Occupation Tax together will be capped at a sum equal to 15% of profit. Since all local companies presently pay tax at the rate of 20% or 35% of their profit, it follows that all local companies will necessarily be better off than they are at present. In other words, these new taxes will only be paid if there is profit, and then up to a maximum aggregate sum of 15% of profit. No company will pay, in respect of both taxes combined, more that 15% of profit. If there is no profit then there is no liability to pay these taxes.

5. In addition, all companies will pay an annual companies registration fee of £300 p.a. (if the company has income) or £150 (if the company has no income) inclusive of current annual return fees.

6. In addition, and subject to EU clearance under State Aid Rules, two sectors of the economy only will pay a new tax on profit. The sectors are financial services providers and utility companies. The intended rate of profits tax for financial services providers is 8%, and will be subject, aggregated to the other taxes, to a maximum cap of 15% of profit.

STATEMENT BY THE CHIEF MINISTER - THE HON P R CARUANA QC TO THE HOUSE OF ASSEMBLY – 12TH JULY 2002

(http://www.borealis.gi/investor/2002/Gib-CM-Tax-Reforms.pdf)

8.2 Responses from the European Union

A statement in April 2003, made by the EU Council of Finance Ministers (ECOFIN) confirmed that the reforms do not constitute harmful tax measures.

However, in April, 2004, the Commission rejected the reforms effectively saying that Gibraltar was part of the United Kingdom and should have the same tax regime, under a principle known as 'Regional Selectivity'.

Gibraltar pointed to its written constitution which enshrines fiscal autonomy and the United Kingdom government is said to be "100% on-side".

Gibraltar is challenging the EC's view at the European Court of Justice.

These plans were also found to breach the State Aid regulations and a court case, the judgement of

which is expected in 2008, is currently in progress on this issue.

8.3 Constitutional differences in the relationship of Gibraltar with the EU and the United Kingdom

Gibraltar is an overseas territory rather than a crown dependency however its legislature has the same responsibilities as the legislature of Jersey, i.e. for all matters other than defence, internal security and foreign affairs.

The main difference is in its relationship with the European Union.

> *Gibraltar is a European dependent territory of the United Kingdom. We have a written Constitution granted to us in 1969 by the British Parliament. Under that Constitution, Gibraltar has its own Parliament and Government, which exercise self-government in all matters except defence, internal security and foreign affairs. These last three are reserved to the UK Government.*
> *As a UK dependent territory, Gibraltar is an integral part of the EC (subject to certain limited and specified derogations) because Article 227(4) of the Treaty of Rome applies the Treaty and Community measures to any European territory for whose external affairs a Member State is responsible. We therefore entered the EC in 1973 at the time of UK accession.*
> *Accordingly, the Gibraltar legislature (House of Assembly) separately transposes all applicable EC directives into Gibraltar's statute law, and EC Regulations and the ECJ Court rulings have direct application in Gibraltar. In the past 3 years, EC law has comprised over 90% of Gibraltar's legislation.*

(http://www.gibraltar.gov.gi/latest_news/topical_speeches/brussels.htm)

> *However, Article 28 of the 1972 UK Accession Treaty gives Gibraltar a special status in that the common custom tariff, the common agricultural policy and the harmonisation of turnover taxes and in particular value added tax do not apply.*

(http://www.fiduciarygroup.com/gibraltar_offshore_information.htm)

Whilst much is made of the importance of the ambiguity afforded by our relationship with the United Kingdom, in other circumstances what appears to be a strength can also be a weakness.

Much of Jersey's future depends on the result of the cases in which Gibraltar is involved, however, without a written constitution attention will have to be paid to the judgement handed down as a lack of the same may not prove favourable for Jersey.

9.0 Assessing the economic impact of the tax reforms

Whilst it must be accepted that the finance industry will seek to take advantage of significant taxation differences between jurisdictions it seems unlikely that this will be the sole criteria on which business decisions are made.

The net effect of these proposals (taken in conjunction with previous proposals on GST) is to raise the level of personal taxation on Jersey residents and trading companies operating within the jurisdiction whilst at the same time significantly reducing the taxation burden on companies comprising the financial services industry.

Whilst many companies had previously negotiated reduced rates of taxation with the Comptroller this was clearly not the case in all instances.

The double tax arrangement with the UK should theoretically allow up to 30% of taxation to be offset against the UK tax chargeable on remittance of profits to the UK, however it is demonstrated that due to the way in which overseas tax (through CFC legislation) is calculated this offset is limited to between 22% (Richard Murphy, Mind the Tax Gap) and just under 20% (Senator Le Sueur, correspondences, Appendix 1) for a company such as Royal Bank of Scotland.

The lowering of the rate to 10% will allow corporations to hold capital within Jersey as only 40% of profits is required to fund dividends (Richard Murphy, correspondences, Appendix 1).

The advantage lies therefore not only in cashflow (as there is an additional year before UK tax is payable on funds remitted if done so at the correct time of year) but also in permanently avoiding the levying of UK tax on the profits of offshore subsidiaries.

There must be some question as to the extent that this process will be tolerated by HM Treasury, however. In the case of the Isle of Man it would seem unlikely that any aggressive lowering of corporate tax funded by the

UK (VAT) taxpayer will be allowed to continue.

In the meantime, the Jersey economy excluding the financial services, will be placed in a non-competitive position.

In the competition over the scarce resource of labour it will lose out to both financial services and the civil service.

In the competition over the scarce resource of land the application of the business rate which will comprise part of the 'all island' rate is unknown however it is hoped that application of this rate will be uniform across all sectors of the industry.

The 'politically-favoured' financial services industry which has served as the cost driver and has provided funding for growth in government expenditure at a rate three times of that of the UK in the period 1980 to 2000 (OXERA, Future of Taxation and Public Expenditure).

The root of the problem thus lies at the feet of Government.

10.0 Conclusions

1. That a 40% maximum be placed on the 'deferred distribution' charge made to shareholders to allow for capital investment in businesses to drive future growth. Whilst it must be hoped that all such investments will prove profitable, it is unlikely to be the case in every instance.
2. That the business rate portion of the all island rate be increased to account for the loss of revenue by the change above.
3. That the anti-avoidance measures indicated are insufficient and there is likely to be additional shortfalls when compared to budget in tax receipts.
4. That due consideration be given to the Constitutional ramifications of the expected future challenge from the European Commission.
5. That further efforts be made to reduce, absolutely, the level of Government expenditure.
6. That 10% tax (with exemptions or significant reductions on all other forms of taxation) on financial services is unsustainable in the medium to long term. As this is the only form of taxation which can be offset against the UK tax liability and assuming that diplomatic efforts to raise this rate which can only be achieved in conjunction with Guernsey and the Isle of Man will not be successful there should thus be no exemption to GST for financial services which will tax the client and not the company providing the services.
7. Jersey's safety net is insufficient to provide for any increased level of unemployment that the planned measures may seem likely to cause.

11.0 Acknowledgement

The views and opinions stated in this submission are entirely my own.

I would like to thank the following people for answering queries and/or furthering my knowledge on areas of which I had not been previously aware, particularly with regard to practices at an international level.

Mariette Davis FCA
Nicholas Friedlos FCA
Senator Terry Le Sueur
Richard Murphy FCA (to 28th April, see correspondence)
Richard Teather FCA

12.0 Circulation

In addition to Scrutiny Officers and members of the States of Jersey, a copy of this submission and the

published proposals will be sent to the following persons:

Rt. Hon. Dawn Primarolo MP
Barry Gardiner MP
Chris Huhne MP

APPENDIX ONE

Correspondence referred to in the submission:

[It is a misconception] 'to assume that RBS has an effective rate of U.K. tax of 30%. Because of other international tax arrangements its effective rate may be rather lower. This is why the 20% rate charged by Jersey was becoming a cost which a bank could not wholly offset against its U.K. rate.'

Senator Le Sueur, 2nd April 2006

RBS worldwide currently pays tax at 22% (2004, source, Mind the Tax Gap). So Jersey tax is relievable in full. Ignore the headline tax rate - for reasons look at Mind the Tax Gap - available from TJN website. It's hard to believe as a result that 20% could not be relieved, but it is just possibly true.

Richard Murphy, 5th April 2006

In theory the offshore advantage of paying low tax is cash flow only - if the parent company ever wanted the profit it would be taxed in the UK. But UK corporate only tend to pay out 40% of profit before tax as dividend which means they don't need to bring all profit back into the UK so the cash flow cost is indefinitely postponed.

Richard Murphy, 6th April 2006

Your comments on appropriate taxation structures suggest your position is far removed from that which I would consider desirable for Jersey or any other state. In that case I will not therefore be assisting you further.

Richard Murphy, 28th April 2006

Controlled Foreign Companies (CFC) legislation apportions the profits of [overseas] companies back to the shareholders.

Richard Teather, 2nd May 2006