BDO Stoy Hayward LLP
Chartered Accountants

8 Baker Street London W1U 3LL
Telephone: +44 (0)20 7486 5888
Facsimile: +44 (0)20 7487 3686
DX 9025 West End W1
Web site: www.bdo.co.uk

Private and Confidential

Senator J Perchard
Chairman, Corporate Services Sub Panel
Scrutiny Office
States Greffe
Morier House
St Helier, Jersey
JE1 1DD

21 December 2006

Your ref: 513/40(1)

Our ref: G:\Office97\humea\Jersey Scrutiny Panel 211206.DOC

Dear Senator Perchard

Re: Corporate Services Scrutiny Panel -Zero/Ten Review

I refer to the email dated 8 December from Sam Power which instructs us to review the "Blampied Proposal" ("the proposal") from a UK direct tax perspective.

The 8 December email and our engagement letter are enclosed for reference. The enclosures should be carefully reviewed as they give direction to the areas of limitation of our scope. Also attached is a document dated 12 October 2006 which summarises the proposal. We have based our advice solely on that description of the proposal.

In order to put our comments in context, find attached an appendix summarising the relevant UK legislation, as enacted at 11 December 2006.

My letter first considers the consequences to a UK tax resident company of dividends paid by a Jersey company under the proposals and then the consequences to a UK individual.

1. Corporate Consequences

UK credit relief – An introduction to treaty versus unilateral credit relief

For both a UK company receiving a dividend from a Jersey company and a Jersey branch of a UK company the same concepts apply in relation to the availability of UK double tax relief (credit relief). To obtain the benefit of relief in the UK for Jersey taxes, the Jersey taxes must be *admissible taxes* for UK purposes.

The starting point in considering the admissibility of Jersey taxes is the tax convention between the UK and Jersey – The Arrangement of 24 June 1952. Article 9 of the Arrangement provides for the "elimination of double taxation", including relief against UK taxes for "Jersey tax payable". Article 9(1) provides for relief for Jersey tax payable in respect of income from sources in Jersey "other than dividends or debenture interest

payable by a company resident in Jersey" but "subject to the provisions of the law of the United Kingdom", thereby giving the UK the right to restrict admissible taxes.

Where no credit is allowed under paragraph 1 (say, in the case of Jersey tax payable in respect of income from dividends from Jersey companies), relief from UK tax is allowed "as would be allowed under the law in force in the UK if the present arrangement had not been made."

As such, a UK resident is able to claim the benefit of the UK unilateral double tax relief provisions in section 790 Income & Corporation Taxes Act 1988 (the primary section in the UK Taxes Act which deals with relief for foreign taxes) both, amongst other things, in relation to the Jersey tax suffered by reference to a Jersey permanent establishment (taxable presence) of a UK company and also by reference to the "underlying tax" of a Jersey company held as to 10% or more by voting power (see below) by a UK company.

In the absence of relief accorded by reference to a double taxation agreement, unilateral relief is granted in the UK in respect of foreign tax payable as a credit against *corresponding* UK income tax or corporation tax (this issue having been considered in the case of *Yates* v *GCA International Ltd* [1991] STC 157 – see below) computed *on the same income* (see *George Wimpey International* v *Rolfe* [1989] STC 609). HMRC consider that foreign tax (however computed) *corresponds* if it is intended to tax the profits of the business; however, UK tax law applies in deciding how much income arises abroad.

Underlying tax relating to a dividend is that which is attributable to the relevant profits of the company out of which the dividend is paid. It is generally only available to a company which controls directly or indirectly (or is a subsidiary of a company which controls directly or indirectly) not less than 10 per cent of the voting power of the foreign company paying the dividend. The relevant profits relating to the dividend are those of any specified period covered by the dividend, or the profits of the last period of accounts made up to the date before the dividend became payable (see *Bowater Paper Corporation Ltd* v *Murgatroyd* (1969) 46 TC 37). The profits are those available for distribution, as shown by the commercial accounts of the foreign company, without any adjustment for reserves, bad debts and contingencies other than those which are obligatory under the appropriate foreign law. The underlying tax that may be claimed for credit relief may be limited where the "mixer cap" formula applies but a consideration of this issue is beyond the scope of our instructions.

Basic rules for unilateral relief

In most circumstances the basic conditions to ensure relief in the UK for foreign taxes are:

1. The source of the income must be in the same foreign country which has charged the tax for which credit is claimed.

2. The credit is given against UK tax *by reference to the foreign tax payable on the same item of income.*

3. The claimant must be a resident in the United Kingdom.

4. The credit is limited to the lower of the foreign tax payable and the UK tax attributable to the income.

5. Foreign tax must be specified in the double tax agreement or have been accepted by the UK authorities as being appropriate for these purposes.

Section 790 includes the following sub-sections which are particularly relevant to the issue at hand in this instance:

(1) To the extent appearing from the foreign provisions of this section, relief from income tax and corporation tax in respect of income and chargeable gains shall be given in respect of tax payable under the law of any territory outside the UK by allowing that tax as a credit against income tax or corporation tax, notwithstanding that there are not for the time being in force any arrangements under Section 788 providing for such relief.

---

(4) Credit for tax paid under the law of the territory outside the United Kingdom and computed by reference to income arising or any chargeable gain accruing in that territory shall be allowed against any United Kingdom income tax or corporation tax computed by reference to that income or gain (profits from, or remuneration for, personal or professional services performed within that territory being deemed for this purposed to be income arising in that territory).

---

(12) In this section and in Chapter II of this Part in its application to unilateral relief, references to tax payable or paid under the law of a territory outside the United Kingdom include only references-

(a) to taxes which are charged on income and correspond to United Kingdom income tax and

(b) to taxes which are charged on income or chargeable gains and which correspond to United Kingdom corporation tax;

but for this purpose under the law of any such territory shall not be treated as not corresponding to income tax or corporation tax by reason only that it is payable under the law of a province, state or other part of a country, or is levied by or on behalf of a municipality or other local body.

It can be seen that one critical issue is that the income on which relief is being claimed is *sourced* within the country where the tax is payable (section 790 (4) ICTA). The determination of source is based on principles of UK law. The Yates case (see below) considered where the income arose that was subject to UK taxation. The conclusion was that "English law and English concepts as to the identification of the place where income arises, must be resorted to for the purpose of answering the question whether all or some part, and if so what part, of the contractual remuneration under the contract was income arising in Venezuela". The judge referred to an earlier 1921 case " FL Smidth and Co v Greenwood" and a 1990 Privy Council case "Hang Seng Bank Ltd". All three cases were consistent in determining that the income arose in the place "where the service was rendered or the profit-making activity carried on".

Secondly, credit for foreign tax paid is allowed against UK income or corporation tax *"computed by reference to that income or gain"* (section 790 (4) ICTA).

Thirdly, as far as unilateral tax credit relief is concerned, references to tax payable or paid under the law of a territory outside the UK include only references to—

- (*a*) taxes which are charged on income and which *correspond to UK income tax*; and
- (*b*) taxes which are charged on income or chargeable gains and which *correspond to UK corporation tax* (section 790 (12) ICTA).

The source of the "income" in the context of the Blampied Proposal is clearly Jersey. The condition that the source of the income must be in the country that has charged the tax for which the credit is claimed is also dealt with by HM Revenue & Customs manuals. These indicate (at paragraph INTM 161110) that "The source of most types of income is normally clear". The example given in the Blampied Proposal document of 12 October is that of a Jersey shop. It is assumed for these purposes that the condition is satisfied. The restrictions on BDO Stoy Hayward LLP's scope of engagement, however, do not require this point to be specifically confirmed.

The most important issues for consideration in this context are therefore whether UK income tax or corporation tax are "computed by reference to that income or gain" and, if so, whether the Jersey tax on notional rental income "corresponds to" UK income tax or corporation tax.

The "comparability" requirement for credit relief

The relevant HMRC internal guidance manual (the International Manual at paragraph INTM161030) states that the requirement for comparability equally applies in the instance of a country where there is a double tax treaty with the UK but the double tax treaty does not cover the category of foreign tax involved.

The latter requirement is key as the HMRC manuals direct tax Inspectors to check that taxes on which relief is sought are either in the relevant double tax treaty or have been approved by the Revenue Policy Group. Should a tax arise on which relief is claimed that does not satisfy either of the conditions then the Inspectors are directed to pass details of the tax to Revenue Policy for adjudication. Should the Blampied Proposal become legislation in Jersey, this adjudication will ultimately occur.

The HMRC manuals (at paragraph INTM 161140) briefly cover the extent to which foreign taxes arise on the same item of income. This includes comment that the test is the "foreign tax on the foreign income is the foreign tax payable in respect of the income from the source for the same year as that for which the United Kingdom tax is assessed". There is no requirement set out in the HMRC manuals for the foreign tax to be calculated on the same basis as that of the UK.

Does foreign tax correspond to UK income tax or corporation tax? – The Yates case

The only tax case which covers the admissibility of a foreign tax is Yates v CGA International [1991 STC 157]. This case is the only one that looks at foreign tax credit relief to consider what constitutes creditable tax, and specifically the issue of whether a tax corresponds to UK income tax or corporation tax.

CGA International Ltd was a company that carried on a trade of petroleum and natural gas consultants and entered into a contract with a Venezuelan company to carry out a technical study of three oil fields in Venezuela. The company received payments for its services, some relating to work performed in the UK and some relating to work undertaken in Venezuela.

Under the Venezuelan tax code, 90% of the gross receipts of the company were deemed to be net profit subject to a tax rate of 23%. This tax was withheld by the Venezuelan company. The UK company claimed double tax relief in the UK by way of credit under section 790 ICTA 1988. The courts held that, on the evidence of the actual language used in the Venezuelan tax code, the intention was to charge net profit to income tax, although the estimation of profits (90% of gross receipts) was arbitrary. Accordingly the Venezuelan tax *did* correspond to UK corporation tax and therefore qualified as a creditable tax.

Although the case is helpful for the Blampied Proposal, I do not believe that it goes far enough to give credit for taxes calculated with reference to property values. This is because one of the findings in the case was that the Venezuelan authorities were attempting to assess a company on its net profits with net profits being calculated by reference to gross receipts. The judge's conclusion includes comment that "in my judgement the tax imposed by the Venezuelan tax code bears all the hallmarks of a tax computed by reference to income and it also corresponds to United Kingdom income tax or corporation tax. I do not believe the Inspector can reject the Venezuelan tax merely because he does not like the figure of 90% of gross receipts". The judgement goes on to state that the gross relief basis was a mechanism for ensuring that a non-resident "for whom it may be difficult to chase for tax liabilities" was subject to a defined taxing mechanism which permitted ease of tax collection.

As a result of the Yates case, the UK authorities issued Statement of Practice 7/91 to clarify when credit may be sought against foreign taxes. The Statement of Practice is brief and the key comments are that "in future the question of whether or not a foreign tax is admissible for unilateral relief under TA 1988 Section 790 will be determined by examining the tax within its legislative context in the foreign territory and deciding whether it serves the same function as income and corporation tax serve in the UK in relation to the business. Turnover taxes, as such, are not admissible for relief." To that end, HMRC maintain a list of admissible and inadmissible taxes which act as a value tool for establishing HMRC's attitude generally to the admissibility of different types of foreign tax. Instructions to tax Inspectors in the context of INTM161310 specify that a "tax should be treated as admissible for credit only if it is shown as such in:

1. the notes on countries in DT2100 [the Double Taxation Relief Manual] onwards, or
2. specific instructions given by Revenue Policy, International, External Relations Group (Advisory)."

By way of illustration of HMRC's attitude to taxes levied by reference to non-income or gains sources, in the case of Benin, inadmissible taxes are specified as including "Land tax (contribution foncière des propriétés non-bâties) and Real property tax (contribution foncière des propriété bâties)".

The Blampied Proposal (which appears to suggest a tax basis by reference to notional income on real estate assets employed in Jersey) would not therefore seem to correspond to an income-based tax; nor does the proposed taxing mechanism appear to have been suggested for "administrative convenience" (Yates v CGA International). Accordingly, I do not believe that the case is supportive of the availability of double tax relief in the UK for a foreign tax which is levied by reference to a notional rental income from non-residential Jersey sited real estate as in this instance.

Does foreign tax correspond to UK income tax or corporation tax? – The George Wimpey case

The case of *George Wimpey International Ltd v Rolfe* [1989] STC 609 made it clear that, in order to claim credit relief, there must be UK tax which is charged with respect to the same income as that on which foreign tax is paid. In that case, a company operating a worldwide construction business made an overall trading loss, but suffered foreign tax in respect of trading profits in three overseas countries. It claimed double taxation relief, in respect of this foreign tax but against corporation tax attributable to non-trading income and capital gains. The UK tax authorities rejected the claim and the court dismissed the company's appeal on the basis that, under section 790 ICTA 1988, credit for foreign tax "shall be allowed against any UK income tax or corporation tax computed by reference to *that* income". The company in this case (as I believe would be the case under the Blampied Proposal) was not chargeable to any UK tax in respect of the income on which the foreign tax was charged. No relief was therefore due.

In conclusion

In summary, I do not feel that a tax based on 20% of actual rent or 20% of market rent for non-residential Jersey property would be an admissible tax in the United Kingdom for either United Kingdom companies with a Jersey permanent establishment or in relation to dividends paid by Jersey companies.

The document dated 12 October indicates that an alternative to a Jersey tax on deemed rental income would be to, in effect, convert the tax on deemed income to actual income by way of the use of property ownership companies. This is a possibility for operations that own the property from which they trade. The practicalities of such a proposal are outside the scope of this document. Additionally, please note that the restriction on scope assumes that all transactions are at arm's length rates. Accounting profits may arise in the trading concern which do not have any Jersey tax liability (and therefore do not have any taxes which can be creditable in the UK). The associated property ownership company will have creditable tax for UK purposes. It is outside the scope of our engagement to consider the quantums of such tax. To the extent that the Jersey tax is at higher rates than corresponding liabilities in the UK (eg because a lower effective rate of corporation tax applies in the UK) then creditable tax may eliminate UK liabilities in full. There may be other consequences for a UK company should the number of "associates" in Jersey increase. These relate to the rate of tax paid in the UK and the due dates for that tax. Consideration of this matter is outside the scope of the assignment.

2. Dividends From Jersey Companies to UK Resident Individuals

As noted at Appendix A, dividends are taxed on individuals within the charge to tax in the UK at a rate of 32.5% irrespective of the percentage ownership by the individual. Our scope does not require us to consider the applicability of anti-avoidance legislation e.g. section 739 ICTA 1988 where UK residents have a "power to enjoy" income by means of a "transfer of assets" abroad. Such legislation may give rise to a differing analysis.

I hope that the above is clear. Once you have had a chance to digest its contents I suggest we have a telephone conference to discuss any questions that you may have.

Kind regards.

Yours sincerely

Anton Hume

Anton Hume
International Tax Partner
Head of Transfer Pricing

Appendix

Basic Summary of UK Taxes

1) Dividends received by a UK tax resident individual from a Jersey incorporated and solely tax resident company are taxed at a rate of 32.5% with no relief given for Jersey taxes paid by the company out of whose profits the dividend is paid.

2) Credit would generally be available for Jersey taxes on income against UK corporation tax, whether the Jersey activity is conducted through a branch of the UK company or a Jersey subsidiary of a UK company which pays a dividend to the UK. In the latter case, the UK parent must have more than 10% of the voting power of the Jersey subsidiary (section 790 ICTA 1988) if UK "underlying" tax relief is to be available by reference to the Jersey tax suffered on the profits of the company out of which that dividend is paid. Where relief for Jersey tax is sought, the Jersey tax must be akin to UK tax. The level of UK tax (calculated under UK principles) is compared to the foreign tax suffered. Relief is available up to the level of UK tax. There are special rules to accommodate taxes paid in different jurisdictions in different years of assessment. Any foreign taxes not relieved in the UK (in the year or under carry back and carry forward provisions) are "lost".

   One of the standard reference materials includes comment that "there is no requirement for the person assessed in the foreign country be the same person as assessed in the UK." However, the sole example given is a scenario where income from a trust may be liable to UK income tax in the hands of a beneficiary and therefore credit may be given to the UK beneficiary for the foreign tax paid by the trustees. I believe that this example arose because of the differentiation between the legal ownership and beneficial ownership of assets arising from a trust structure and therefore cannot be relied upon for other purposes. This understanding may have consequences for the Blampied Proposal where a property ownership company is envisaged.