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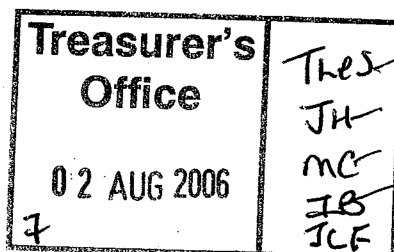

31 July 2006

Our ref: JAS/NB41/mg

Dear Sir

The Zero/Ten Design Proposal – Zero should mean Zero

We are writing in response to the consultation document issued on 5 May 2006.

A full response to the consultation document is being forwarded to you by Jersey Finance Limited and we broadly agree with the comments in their letter. Our purpose in writing separately to you is to add further comments on the deemed distribution charge and deferred distribution charge, and how to deal with tax avoidance under the new system. We strongly believe that the proposed approach is flawed from a practical and technical standpoint, and we are concerned that the Jersey Finance Limited does not make this sufficiently clear.

The Zero/Ten proposals have naturally provoked a good deal of interest and comment in Jersey, and since the document was issued we have been involved in a number of discussions about the proposed measures with our clients and in wider industry groups. This response is based in part on those discussions and also on our own knowledge and experience of taxation in Jersey and elsewhere.

The introduction of Zero/Ten creates a potential problem in Jersey, because many local companies which are currently tax paying will move to a zero tax rate. We are aware that this problem has created a good deal of concern in the Island and we agree that this concern needs to be addressed before the proposals are implemented. In this letter we aim to contribute constructively to the debate, commenting on the current proposals and some potential alternatives, before putting forward what we believe is the best overall solution for Jersey. We would be very happy to discuss our thoughts further with you in the coming months.

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Deemed distribution charge and deferred distribution charge

The primary problem with these proposals is that they require the state to interfere in company distribution policy. A company is a legal person, with rights and duties separate and distinct from those of its members. Directors are responsible for managing the company. The Zero/Ten proposals would require directors to be guided not by the interests of the company but by tax legislation and the position of individual Jersey resident shareholders. In many situations the position of shareholders will vary, but because the company must distribute, shareholders who are not resident in Jersey, or who are not taxpayers, are forced to receive distributions regardless. The problem is particularly acute under the current proposals, because after 2011 there is no period of roll up. For this reason we believe the proposals should be reconsidered.

A number of additional technical difficulties have been identified in the Jersey Finance Limited letter. The main ones are:

- The three year roll up period (24.4) in fact operates as a one-off three year holiday for all companies when the rules are introduced. Thereafter, companies must distribute all profits each year to avoid the deemed distribution charge.
- This in turn presumably makes the deferred distribution charge unnecessary after 2011.
- Basing tax on GAAP profits will potentially create inconsistency between taxpayers and will also require the Comptroller to master and police international accounting principles, as there is currently no requirement for the majority of Jersey businesses to prepare audited accounts.[1] There will be enormous potential for manipulation of profits subject to the charge.
- Even if one were to accept that undistributed profits are in reality a shareholder loan (26.1.2), it is not clear why the States should get the equivalent of interest on the "loan" through a 4% (20% X20%) tax charge. One would expect any such tax to be calculated on the interest and not on the undistributed profits.
- The proposals are complex enough when seen in the context of a company wholly owned by Jersey taxpayers with simple ordinary share capital and with only trading income. However, they quickly become much worse when one factors in the many varieties of security which are commonly used in company structuring and the many different types of income/capital which a company might receive (property income, capital gains, etc.).

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[1] Of course, the alternative would be to use tax-adjusted profits as the base for the charge, but this would be just as problematic because of the difference between tax-adjusted profits and realised profits available for distribution.

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Purpose of the deemed and deferred distribution charges

Before looking at alternative solutions, it might be helpful to recap on why these measures are being proposed. From conversations with officers and politicians we understand there are two main objectives:

1. Preventing tax avoidance which it is feared will be triggered by zero tax, because shareholders will roll up profits in trading companies and thus delay tax payment (because dividends are delayed) or avoid tax altogether by using share disposals/liquidation to realise a tax free capital gain.
2. Protecting the tax base by taxing corporate profits on a basis as close as possible to the current one, regardless of the zero headline rate of corporation tax, in order to protect the tax base.

Preventing tax avoidance

Tax avoidance legislation should aim to be proportionate. The first step should therefore be to quantify the avoidance, because unless this is done it is impossible to judge the right response.
We do not believe that the introduction of zero/ten will result in large numbers of private company shareholders changing their ongoing cash requirements to a significant extent. As a result we think a given level of dividends will probably continue to be paid by most companies. If there is an attempt at avoidance, this ought to be fairly obvious from a review of company accounts, by reviewing distribution policy and shareholder transactions. A simple system of disclosure ought to therefore be sufficient to enable the Comptroller to assess whether or not the current general anti-avoidance rule has been breached. It may even be worthwhile considering taxpayer self-assessment or a more formal clearance system as a means of reinforcing the general anti-avoidance rule. Both would be preferable to the proposed deemed distribution rules.

Others may feel that the level of avoidance would still be unacceptable. It would be helpful to have evidence to support this before Jersey embarks on such a problematic course. So far we are not aware that any detailed and robust estimates of the likely tax loss (cashflow or absolute) have been prepared. As an absolute minimum, we believe that the States should review the available data once more and demonstrate conclusively that the avoidance is going to create a significant long term problem in public finances, taking into account the tax that will continue to be paid on dividends and in the locally-owned financial services sector.

Our final comments on anti-avoidance are drawn from the Chartered Institute of Taxation[2].

[2] Tax Legislation In The UK: Complexity, Avoidance And Other Issues: 2006

"Using tax avoidance as a justification for detailed changes...is counter-productive:

- It makes for ever more complicated legislation, often creating future avoidance opportunities and causing injustice for those who fall foul of the new rules but have no tax avoidance motive.
- It can have wider effects, going beyond the targeted abuse....
- Knee-jerk drawing of a new set of complex rules around a "scheme" is not the only possible response – the alternative is to re-examine the basic approach taken by the legislation."

We believe that in this case "the basic approach taken by the legislation" (i.e. Jersey's general anti-avoidance law) should be the starting point and that Jersey should only then introduce specific legislation in rare and very specific instances. Indeed, in our experience specific legislation is usually more likely to stimulate avoidance than discourage it.

Restoring the status quo

The second motive is about introducing zero/ten for companies, but then trying to return to the status quo by introducing a raft of measures which combine to arrive at (at least) 20% income tax on corporate profits. There is something rather disingenuous about this approach which is not helpful to Jersey's image; the headline rate of tax is still of tremendous importance to the way Jersey is seen internationally, and it is not helpful for the "real" rate to be something else.

As a result, we believe the proposals could severely impact investment. Wealthy individuals considering residence in Jersey will find, to their surprise, that zero/ten isn't really zero/ten at all and will quickly be wading in the treacle of our distribution provisions. A real opportunity to position Jersey as a great base for the generation of new entrepreneurial activity (both in finance and outside it) will have been wasted because our proclaimed zero tax rate is really nothing of the sort.

Our experience of talking to interested groups, including potential new 1(1)Ks and teams of fund managers, backs this up. Seen from onshore UK, our combination of 20% income tax, low social security and no capital gains tax is extremely attractive. Many of the potential new residents we talk to would be happy to pay income tax to some degree on their company profits, but are discouraged by the complexity of a deemed distribution charge and feel uncomfortable that the tax system doesn't really offer what is advertised. The proposals risk putting off those people who would invest in the Jersey economy, and attracting only the ones who would be passive residents in the Island.

For existing Jersey businesses, we believe the provisions will introduce an unacceptable level of complexity. Many of our clients, including those who would have been perfectly comfortable with their companies continuing to pay income tax on their profits at 20%, are extremely unhappy at the prospect of a complicated system of smoke and mirrors arriving at the same result. The complexity is, for them, bewildering. Some significant second or third generation Jersey family

companies stand to suffer, because typically shareholders will be spread around the world and there may be varying rights to dividends. In our view, the proposals will therefore discourage new entrepreneurial activity and will make it harder for existing Jersey businesses to reinvest for the future, particularly in capital-intensive sectors.

If protecting the tax base is still a concern, we would repeat that the tax leakage should be properly quantified as a next step. If there is significant leakage, and we suspect that in the main it would be a cashflow cost, we would submit that that is a necessary cost of introducing the Zero/Ten policy, and other methods of funding the cashflow cost should be considered.

Potential alternative methods of taxing shareholders

A number of variations to the deemed distribution charge have been put forward. None of these is in our view attractive.

1. *Making the shareholder liable for the same amount of tax but requiring the company to pay it as agent* In our view, calculating a tax on company profits and requiring the company to pay it is effectively corporation tax. The tax could not be collected from companies with non-resident owners (because it would still be a tax on shareholders in law) and we would therefore be concerned that the requirements of the Code of Conduct Working Group would not be met. There would also be the same difficulties over how to calculate the tax (accounting profits versus taxable profits). Tax paid by the company would be a distribution, requiring additional distributions to be made to other shareholders with no tax liability.
2. *Giving the shareholder a statutory right of reimbursement against the company for his tax* Whilst this may be more likely to comply with Code principles, in other respects it carries the same disadvantages as 1.
3. *Limiting the proportion of profits which are subject to the charge* This is the preferred approach in the Isle of Man, where the "forced" distribution rules will apply to only 55% of profits. We think this approach mitigates the problems to a large extent, but does not deal with the fundamental issue of protecting the company as a person legally separate from its shareholders. Administrative complexity would continue to be a problem.
4. *Creating a "true" roll up period of three years* This would at least mitigate some of the problems of the annual distribution charge, but we would question whether it generates enough tax to be worth the complexity and administration burden, especially if roll up is reduced to a minimum through use of the general anti-avoidance rule (see below).

Taxing company profits only when dividends are paid

The final alternative is, of course, to tax Jersey shareholders only when they receive a dividend. It will not surprise you to learn that this is by far the most popular alternative when we discuss these matters with our clients. Nevertheless,

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we think this basis has a number of attractions for government as well as for taxpayers:

- It provides a stimulus for investment in the business community.
- It plays a part in wealth generation by encouraging new entrepreneurs to the Island.
- It removes one part of the perceived inequity between locally owned and non-locally owned traders, because corporate profits are only taxed when a dividend is paid regardless of where the shareholder is situated (removing some of the basis for the "RUDL" charge).
- It removes a significant burden of administration from the Tax Office.
- It removes the potential for Jersey's image to be damaged by a zero rate which is not really zero.

In moving to this basis one would need to address the potential disadvantages too. In our view the principal problems are (a) the possible cashflow cost in terms delayed receipts, which we think needs to be quantified, and (b) the need to rethink the way in which our general anti-avoidance rule is policed.

In expressing these views we are aware that we may be acting against our own best interests, because the other side of the complexity of the current proposals is the increased opportunity for tax planning. We feel this should not prevent us from putting forward a solution which we believe is in the best overall interests of the Island and its business community.

Yours faithfully

PricewaterhouseCoopers CI LLP