States of Jersey
States Assembly

États de Jersey
Assemblée des États

Corporate Services Scrutiny Panel Report

Review of the Zero/Ten Tax Design Proposals – Draft Shareholder Legislation

Fourth Report

Presented to the States on 7th November 2007

S.R.20/2007

Contents

1. Executive Summary

The Panel:

Deemed distribution

On balance supports the deemed distribution proposals as the least bad method of collecting tax from local shareholders. As deemed distribution will only be 60% of a company's profits a Jersey-owned company can still retain at least 40% of its profits for reinvestment. **(Section 4)**

Jersey's international obligations

As to whether deemed distribution will satisfy Jersey's obligations under the EU Code of Conduct, and also be Human Rights compliant, the Panel notes that the proposals are a higher risk than a "distribution only" policy would be. However Jersey's proposals are a significantly lower risk than the Isle of Man's (which were recently rejected by the EU Code of Conduct group), and if problems were encountered with the EU Code of Conduct, or Human Rights legislation, it would be possible to move to a distribution only system through an amendment to the Regulations.[1] **(Section 4)**

Tax evasion

Notes that Zero/Ten will increase the opportunities and appetite for tax evasion by Jersey-resident individuals. The ownership of Jersey companies could be disguised by having their shares owned by a trust or an offshore group, and despite the new powers of the Comptroller it could in practice be difficult to prove ownership; this will be even easier for newly-formed companies. **(Section 5)**

Tax avoidance

Further notes that it would be possible to avoid having a Jersey company at all, particularly for a new business which could incorporate in Guernsey (especially if the business is to operate on both Islands). This could therefore lower the amount the Tax Office receives from the deemed distribution and look-through provisions, as the deemed distribution rules will not apply where there is no Jersey-resident company. **(Section 6)**

[1] Draft Income Tax (Deemed Dividends) (Jersey) Regulations 200- (P.157/2007)

Investment distortion

Notes that it would be more advantageous for a Jersey resident to invest in off-Island companies, whereas off-Island investors could have an advantage when bidding for a Jersey company. In economic terms, these two factors could cancel each other out. However, we are concerned that Zero/Ten may result in a decline in Jersey-owned businesses and thus seriously affect tax revenues.

There may also be social implications associated with a decline in locally owned and locally ‘loyal’ employers. The relevant Scrutiny Panel, or Panels, might wish to give this scenario some serious consideration. **(Section 7)**

Taxing foreign owned trading companies

Is concerned that so much time has passed since the Minister for Treasury and Resources was first asked to consider the proposal for a tax on owner-occupied business property, and urges the Minister to examine the economic impact and potential yield from this tax and report on his findings as a matter of urgency. **(Section 8)**

Comptroller’s powers (Article 20b)

On balance accepts the proposal to increase the Comptroller’s powers, in an attempt to reduce the above problems of increased opportunities for avoidance and evasion under the Zero/Ten system. The Panel is concerned however at the potential for increased tension between the authorities and taxpayers as a result. **(Section 9)**

Exemption from deemed distribution for quoted companies

Is concerned that the proposal for exemption from deemed distribution for companies quoted on a “recognised stock exchange” is unnecessary and risks increasing avoidance further. We therefore recommend that this exemption should be removed, and have lodged an amendment accordingly. **(Section 10)**

De minimis limit

Is concerned that the proposed de minimis, whereby shareholdings of less than 5% in a company will be exempt from tax on deemed distributions, would enable significant shareholdings to avoid tax (until a dividend is actually paid), and therefore recommends that 2% would be a better compromise between administrative efficiency and fairness. We have therefore lodged an amendment accordingly. **(Section 11)**

Distinction between a trading company and an investment company

Believes that the current definition is satisfactory, and is pleased to note that the Treasury have abandoned their original definition and adopted a more practical basis. **(Section 12)**

Calculation of deemed distributions

On balance supports the decision to calculate deemed distributions on a “tax profits” basis rather than an “accounts basis”. The Panel notes that this causes an increased risk of the proposals being rejected by the EU, or leading to challenges under the Human Rights legislation. **(Section 12)**

Shareholder loans

Is concerned that the exemption for shareholder loans being taxed as distributions if the shareholder is charged a commercial interest rate gives scope for tax avoidance. It is noted that Article 134A of the Income Tax legislation should provide the Comptroller with the appropriate powers to ensure this exemption is not taken advantage of. However, this situation will need to be monitored. **(Section 12)**

Panel Membership

The Corporate Services Scrutiny Panel is constituted as follows –

Deputy P. J. D. Ryan, Chairman
Connétable J. Le Sueur Gallichan
Connétable D. J. Murphy
Deputy C. Egré

Officer support: Mr M. Haden and Miss S. Power

Independent Expert Advice

The Panel engaged the following advisers to assist it with the review –

Mr. Brian Curtis, FCIB, MSI (dip.), PFS, FInstD, has worked in Jersey's Finance Industry for some 35 years and is currently involved with a number of activities within the industry and the voluntary sector.

Mr. Richard Teather, BA, ICAEW, a senior lecturer in Tax Law at Bournemouth University; a Freelance Tax Consultant and a writer on Tax Law and Policy.

Terms of reference

The Corporate Services Scrutiny Panel approved the following terms of reference for the third phase of the review of the Zero/ten design proposals:

To review the second part of the Zero/Ten Draft Legislation, and any areas of concern raised by the Zero/Ten system as modified by that draft law, with a particular focus on the following areas –

1. *The provisions for taxing Jersey-resident shareholders;*

2. *The provisions (or lack thereof) for obtaining revenues from non-Jersey owned companies;*

3. *The distributional effects and equity of the proposed Zero/Ten system;*

4. *The effectiveness and fairness of any anti-avoidance measures and disclosure obligations;*

5. *The extent to which the proposed legislation meets the concerns raised in the Panel's first two reports on Zero/Ten; and*

6. *The extent to which the obligations under Jersey's agreement with the EU have been satisfied.*

Documentation

The following documents were considered when compiling this report, and are available on the Scrutiny website (http://www.scrutiny.gov.je/):

Draft Income Tax (Amendment No.29) (Jersey) Law 200- (P.156/2007)

Draft Income Tax (Deemed Dividends) (Jersey) Regulations 200- (P.157/2007)

Review of the Zero/Ten Design Proposal, Corporate Services Scrutiny Panel (S.R.4/2006)

Review of the Zero/Ten Tax Design Proposals, Corporate Services Scrutiny Panel (S.R.3/2007)

Review of the Zero/Ten Tax Design Proposals – Taxing Foreign Owned Trading Companies, Corporate Services Scrutiny Panel (S.R.14/2007)

Hearings

The following witnesses attending hearings with the Panel:

16th August 2007

Senator Terry Le Sueur, Minister for Treasury and Resources
Mr Malcolm Campbell, Comptroller of Income Tax

A verbatim transcript of the hearing is available on the Scrutiny website.

2. Proposed Amendments to the Draft Law

We propose amendments to the following articles of the draft law in order to bring about the change specified below:

1. **Articles 33(b) and 38** – to remove the exemption from deemed distribution for quoted companies. **(See section 10 of our report)**

2. **Articles 38 and 41** – to reduce the proposed de minimis limit from 5% to 2%. **(See section 11 of our report)**

3. Introduction

The Corporate Services Scrutiny Panel has already presented three reports to the States on the Zero/Ten Proposals:

- Interim Report **(S.R.4/2006)**, presented to the States on 28th September 2006. This report was based on the initial consultation document released by the Treasury, dated 5th May 2006.
- Second Report **(S.R.3/2007)**, presented to the States on 23rd January 2007. This report examined the Treasury and Resources Minister's revised proposals contained in R.80/2006 and the first part of the Zero/Ten Legislation (i.e. that dealing with the taxation of Jersey companies).[2]
- Third Report **(S.R.14/2007)**, presented to the States on 4th September 2007. This report focused on Jurat Blampied's proposed mechanism to tax foreign owned trading companies.

This is therefore the fourth stage of the Panel's Review into the Zero/Ten proposals, and it is focused on the second part of the Zero/Ten legislation package. The States have already passed the core Zero/Ten provisions, introducing the 0%, 10% and 20% rates for companies. This part of the legislation deals with shareholder taxation.

Under the first part of the legislation almost all companies will be taxed at 0%, the exceptions being utilities (20%), property companies (20%) and financial service providers (10%). This change in corporate taxation was necessary for two reasons. Firstly, Jersey's commitment to the United Kingdom to comply with the EU Code of Conduct on Business Taxation. Secondly, to achieve a more competitive corporate tax rate for our financial services industry.

Under Jersey's commitment to the UK and the EU, the Island agreed to scrap the system whereby many companies owned by non-residents (particularly those set up in the course of a financial services transaction) would pay a lower tax rate than Jersey's general rate of 20%. This system was seen as discriminating in favour of non-resident companies, and therefore "harmful".

[2] Draft Income Tax (Amendment No.28) (Jersey) Law 200-

However, to be successful the finance industry needs tax-free companies for its clients, and Jersey needs the jobs, the tax on the employees' salaries and the tax revenues, even at a lower rate, on the profits of local companies dealing in financial services. Therefore, the only way to meet Jersey's obligations without destroying our Island's prosperity is to make all (or almost all) companies tax free by establishing the general rate at 0%.

Other jurisdictions are already charging considerably less than the current 20% rate and are actively seeking to attract business, and Jersey financial services businesses, away from Jersey. The 10% financial services rate is therefore felt to be appropriate and to have addressed this problem before it became a serious one. It is allowable under the EU Code of Conduct to charge a higher than the "standard" rate for a relatively small number of companies within a jurisdiction. So it is not anticipated that having a higher rate for financial services will cause any problems. This is in recognition of the problems that a relatively small number of very high turnover companies can cause in relatively small economies, by soaking up resources otherwise needed for the remainder of the economy.

Zero/Ten therefore proposes that most limited companies residing in Jersey will pay no income tax here, even if it is doing business in Jersey (whether it is a shop, or a service business such as car repairs, or an investment company), and this is regardless of who owns it. The main exception to the rule is utility companies and property companies. The EU Code of Conduct regards such companies as completely "immovable" in any jurisdiction, and therefore considers utility companies and property companies to be outside the scope of the code. We can therefore continue to tax utility companies and property companies at the current standard rate of 20%.

However, this would mean that there would be no tax on the profits of those Jersey businesses that are run by limited companies, whilst employees (and the self-employed who do not operate through companies) would pay at the normal personal income tax rate of 20%. This second part of the Zero/Ten legislation therefore tries to collect some tax from the profits of these Jersey businesses, by taxing the local people who own shares in the company.

This report will summarise the proposals contained within the draft shareholder legislation, and highlight the issues that the Panel believes still need to be addressed. A summary of the amendments the Panel will be bringing forward to the draft legislation can be found on page 7.

3.1 Summary of alternative ways of taxing Jersey-resident shareholders

There are four main ways that Jersey people could be taxed on the profits of the companies in which they own shares:

a. Actual distribution basis

Under this method shareholders would only be taxed when they actually receive a dividend from the company; until then there would be no tax. This is the simplest method, and the one adopted by Guernsey, but there are two major disadvantages for the Treasury:

- ***Cashflow*** disadvantage – it could be years before any dividends are paid, and therefore before any tax is received.
- ***Avoidance*** – shareholders could avoid the tax, for example if the company just paid one large dividend every few years, and in that year the shareholders made sure that they were not tax-resident in Jersey.[3]

b. Deemed distribution basis

If the company does not pay a dividend, this method taxes the shareholders on the dividend they could have received had the company chosen to do so.

The deemed dividend could be the maximum that the company could pay (i.e. its entire accounting profits for the year), or just a percentage of that (to recognise the fact that most businesses do not pay out all of their profits but keep part back for reinvestment).

c. Look-through

Under this method the company is ignored for tax purposes, and the shareholders are taxed on their share of the company's profits for the year (just as they would be if it were a partnership).

[3] It would be possible to have a deemed dividend system (see below) that only operated when a shareholder becomes non-resident or sells his shares.

d. Company acting as agent

This is an enhancement of the ‘deemed dividend’ or ‘look-through’ methods. The tax is calculated just as it would be for ‘deemed dividend’ or ‘look-through’. However instead of collecting the tax from the shareholders the company is made responsible as an ‘agent’ of its shareholders for the calculation and payment of its shareholders’ tax liabilities. This might include a certain amount of negotiation with the tax office as well.

4. The draft legislation – taxing shareholders

Part 7 of the draft shareholder legislation uses the following methods for collecting tax from Jersey residents on the profits of the companies in which they own shares:

4.1 Deemed distribution basis for trading companies

This has changed significantly since the Treasury's original proposal, which the Panel criticised for being too complicated (see our report S.R.4/2006).

Jersey resident shareholders who own shares (directly or indirectly) in a Jersey trading company will be taxed on:

- any dividends they actually receive from the company; and
- if the company pays less than 60% of its profits as a dividend, an additional "deemed dividend" large enough to bring the total dividend up to 60% of the company's profits.

Under the lodged law, deemed distribution does not apply to:

- Shareholders who own less than 5% of the shares in the company; or
- Companies that are quoted on a "recognised stock exchange"

Those shareholders will only pay tax when they actually receive a dividend.

Deemed dividends do not apply to Jersey utility companies, because under 0/10 these companies will still be taxed at 20% on their profits.

4.2 Look-through for investment companies

Jersey-resident shareholders who own shares (directly or indirectly) in a Jersey investment company will be taxed on their share of the company's full profits, whether or not it pays a dividend.

When the company actually pays a dividend, the shareholder will not have to pay any further tax on that because they will have already paid tax on the company's entire profits through the look-through provision.

4.3 Mechanics of look-through & deemed distribution

Jersey companies will be obliged to inform the Tax Office of their profits and their Jersey-resident shareholders. Subject to an individual's tax-free allowances, the Jersey-resident shareholders will then pay income tax at 20% on:

- their share of the company's income, for an **investment company**
- 60% of their share of the company's profits for a **trading company** (or the actual dividend they receive, if higher)

The only times a Jersey resident shareholder will pay tax on actual dividends should be:

- When a Jersey trading company pays out more than 60% of its profits as dividends (because the deemed dividend basis only taxes 60% of the profit, so the other 40% has not yet been taxed);
- When a Jersey resident individual receives a dividend from a non-Jersey company.

There will also be some anti-avoidance measures to prevent shareholders from receiving money from a company without declaring a dividend (for example benefits in kind and loans received from a company will be taxed as if they were dividends).

Another change from the Treasury's initial proposals is that 'profits' will be calculated under the existing tax rules, rather than being merely the company's profits as shown in its accounts (under proper accounting principles).

This has advantages of certainty, and removes the possibility of taxpayers avoiding tax by manipulating accounting rules (for example reducing profits by making large provisions). However it conflicts with the basic principle of deemed distribution; shareholders should be taxed on the dividend that they could receive from the company, and that by law has to be calculated under accounting, not tax, rules. This also increases the risk of being rejected by the Code of Conduct group, because using tax rules means that the company will have to negotiate with the Tax Office to agree the amount of deemed dividends on which the shareholders will pay tax. This makes the system look slightly more like a business tax (and hence subject to the Code) rather than a personal tax.

4.4 Examples of the look-through and deemed distribution provisions

Look-through and deemed distribution will only apply to individuals who are tax resident in Jersey and own shares in a Jersey company. However they will still apply if the Jersey individual owns shares in the Jersey company indirectly, for example via a Guernsey company or a trust.

In some situations, if taxpayers are uncooperative the Tax Office may have problems with proving indirect ownership. This will particularly be the case where shares in a Jersey company are owned by a company in a jurisdiction where shareholder registers are not publicly available (such as Cayman).

A few examples of how the look-through and deemed distribution provisions would work:

A St Helier shop, owned by a Jersey-resident company with Jersey-resident shareholders

Shareholders taxed on deemed distribution

A St Helier shop, owned by a Jersey-resident company, which is owned by a Guernsey company with Jersey-resident shareholders

Shareholders should pay tax on deemed distribution
Identity of shareholders of Guernsey company may not be available

A St Helier shop, owned by a Jersey-resident company, which is owned by a Guernsey trust with Jersey-resident beneficiaries

Shareholders should pay tax on deemed distribution
Identity of trust beneficiaries not available

A St Helier shop, owned by a Guernsey incorporated company with Jersey-resident shareholders

Shareholders taxed on actual distributions only, unless anti-avoidance law applies
Shareholder identities may not be available

A Guernsey shop, owned by a Guernsey incorporated company with Jersey-resident shareholders

Shareholders taxed on actual distributions only

4.5 Comparison with other jurisdictions

In order to comply with the EU Code of Conduct on Business Taxation the three Crown Dependency Islands have all proposed strategies based on the taxation of individuals on the profits of the companies they own, rather than taxing the company itself. It is believed that this has the effect of moving any residual discrimination into the realm of personal taxation rather than business taxation, and consequently outside of the remit of the EU Code of Conduct Group.

Isle of Man

(Prior to the 26th October 2007) ***Company acting as agent (option d above)***

Panel rating – **Risky** - We have always rated this as risky on the basis that this looks very much like a company tax, and therefore the residual discrimination would clearly fall within the Code of Conduct Group's remit.

On the 26th October the Isle of Man confirmed that the Code of Conduct Group had rejected their proposals having determined that "company acting as agent" was indeed a discriminatory company tax against locally owned trading companies, and therefore in contravention of the EU Code of Conduct on Business Taxation.

Had the Isle of Man's proposals been accepted it is likely that both Jersey and Guernsey would have wanted to follow this model, for it would have resulted in a considerable simplification in the administration of the new system and a significant reduction in tax revenue leakage from local trading companies due to Zero/Ten.

(Post 26th October 2007)

It is too early to properly analyse the Isle of Man's new position at the time of publication of this report, but initial indications are that the Isle of Man's new proposals may be close to Jersey's (outlined below). However they seem to be retaining the controversial option for a company to choose to pay 10% tax, in return for which the shareholders will not be subject to tax on deemed distribution.

Jersey

Deemed distribution of 60% (option b above)

Panel rating – **medium risk**. It is felt that the deemed distribution model is sufficiently integrated into the personal tax system for it to be accepted by the Code of Conduct Group as a personal tax rather than a business tax. However it still discriminates against the local shareholders of local trading companies, but so long as that discrimination is in the field of personal rather than business tax it will not contravene the Code of Conduct.

There is also the further risk that in certain circumstances deemed distribution could be in breach of Jersey's Human Rights legislation because minority shareholders could be required to pay tax on their share of a company's profit without actually having received the money. However this risk is thought to be slight.

Guernsey

Actual Distribution (option a above)

Panel rating – **low risk**. This overcomes both the discrimination problem, because both local and non-local shareholders would be treated identically, and also eliminates the Human Rights concerns because a shareholder will only ever pay tax on the actual dividends received from his shareholding in the company at the point in time that it is paid to him and therefore he has the money to pay the tax.

All three jurisdictions

Look through for investment companies (option c above)

Panel rating – **low risk** Investment companies owned by local residents are generally felt to exist simply as a more convenient means for individuals or groups to hold investments that would otherwise be held in those individuals' names privately. For this reason 'look through' (on 100% of profit) is felt to be acceptable to the EU Group, with the taxation of these companies not being classed as business taxation in the true sense.

4.6 Human Rights Act

The Human Rights issue centres on minority shareholders, who might not have sufficient influence on the dividend policy of a local trading company, but would be obliged to pay tax on their share of the company's profits, even though the company hasn't declared a dividend and paid it to them.

However this risk is thought to be slight. The shareholder has received a benefit from the company's profits (the value of their shares will have increased), they have merely not received any cash. There are numerous examples of provisions that charge tax where no cash has been received, including rates and income tax on employees' benefits in kind.

However deemed distribution tax may help majority shareholders to force out minorities. If the company refuses to pay dividends, and the minority shareholders have no other funds to pay the tax on deemed distributions, they may feel pressured to sell their shares, and may only be able to sell them to the majority shareholder. This may constitute a breach of Human Rights, although it only exacerbates the existing problems of minority shareholders rather than creating a new injustice.

There is a further aggravation to the Human Rights issue if deemed distribution is based upon taxable profits rather than accounting profits. By law if a company declares dividends in excess of its accounting profit the Directors could be personally liable. "Accounting" profits are likely to be at a lower level than "taxable" profits. Taxable profits are when the tax authority seeks to add back certain deductions made by accountants (sometimes under GAAP for larger companies) before calculating the profit upon which tax should be paid. So again, it is possible that shareholders would be obliged under certain circumstances to pay tax upon a higher level of profit than company law would permit to be paid out as a dividend.

4.7 Conclusion

Deemed distribution potentially gives companies with off-Island shareholders an advantage over Jersey-owned ones, because off-Island owned companies pay no Jersey tax (and the shareholders will probably be able to avoid tax in their own country until they actually receive a dividend), but Jersey shareholders will pay tax on a deemed dividend whether or not they actually receive any money from the company.

This could cause social problems (if it discourages local ownership of Jersey businesses), carries some risk of being rejected by the EU Code of Conduct group, and raises some minor concerns over the Human Rights Act.

The Guernsey position of 'actual distribution ' overcomes all of these risks and is the only real alternative to deemed distribution. The 'actual distribution' model would help to encourage local investment, but it would give the Treasury a cash flow problem, of up to £20 million per year based on current estimates, because shareholders would not pay any tax until they actually receive a dividend.

The Panel notes however that the mechanism within the law to apply the deemed distribution rate (of 60% of 'taxable' profit) is within Regulations rather than Primary Law. This would mean that a change to the rate could be achieved at very short notice. A change to 0% would equate to 'actual distribution'.[4]

The Treasury Minister has been faced with a difficult choice. Actual distribution holds the least risk and brings potential economic benefits for the Jersey economy but loses the most tax revenue.

The decision has been further complicated by the actual performance of the Financial Services Industry since Zero/Ten was first mooted and the basics of the Fiscal Strategy passed by the States in May 2005.

Even before that date and in essence since the Island first made the commitment to the UK to comply with the requirements of the EU Code on Harmful Practices in Business Taxation, the Industry has undergone some subtle changes in the way it has marketed itself to the International Community.

Basically the new message has been that Jersey has moved on from being a tax based offshore finance centre (a 'tax haven') to a much more broadly based centre of excellence for financial services of all kinds.

Further impetus to this change in Jersey's stance came from the separate agreement to participate in the European Savings Tax Directive, and Jersey's active participation in the various international initiatives on anti money laundering and the financing of terrorism.

[4] Under the draft law there is a 100% deemed distribution when a shareholder ceases to be non-resident in Jersey, so that the shareholder is taxed on all remaining untaxed profits of the company. Ideally this would be retained, if permitted, even if there is a general 'actual distribution' basis, otherwise shareholders could avoid all tax by moving offshore every five or six years to receive a large accumulated dividend tax-free.

We continue to develop our ‘International Identity’ and reinforce our ‘moral high ground’ stance, with the encouragement of the UK Government, through the signing of Tax Information Exchange Agreements (TIEA’s) with other countries both in the EU and outside of it.

Both Government, through statements from Ministers, and the industry leaders through Jersey Finance Limited, attribute significant importance to Jersey’s relatively new ‘Internationally Responsible’ image as being a major contributor, alongside fiscal certainty, to the recent spectacular growth of the industry.

The Minister has had to balance this scenario, and the possible damage to Jersey’s image painstakingly built over the last few years, that would follow a clash with the EU Code Group; and the local political implications of a larger than expected ‘black hole’ that would be the result of ‘Actual Distribution’.

The Panel therefore and after much thought, on balance supports the deemed distribution proposals as the least bad method of collecting tax from local shareholders.

However the Panel is concerned that the deemed distribution proposals are higher risk than Guernsey’s proposals (as we will be taxing ‘deemed dividends’ rather than ‘actual dividends’ and these being based on ‘taxable’ profits rather than ‘accounting’ profits).

The States should be aware however that a rapid move to ‘actual distribution’ with the consequent tax revenue loss, will be required if the Island’s proposals encounter problems with the EU Code of Conduct Group. The Panel is pleased to note that because the ‘deemed distribution’ rate is prescribed in Regulations it would be simple to move quickly to ‘actual distribution’ by changing the rate to 0%

The Panel also urges the Minister to urgently assess the specific risk of a minority shareholder appealing a ‘deemed distribution’ and/or the ‘taxable profits’ basis of a tax assessment in the Royal Court under the Human Rights Law.

There are several further problems, which are considered in more detail in sections 5 (Tax evasion), 6 (Tax avoidance) and 7 (Investment distortion).

However these problems are less severe than they might have been, because for trading companies the deemed distribution will only be 60% of a company's profits rather than 100%. A Jersey-owned company can therefore still retain at least 40% of its profits for reinvestment (and potentially 88% of its profits, if it only pays sufficient dividends to enable the shareholders to pay their tax on the deemed distribution).

5. Tax evasion

Zero/Ten will increase the opportunities for tax evasion by Jersey-resident individuals. Whether there is actually a significant increase in evasion will depend on taxpayers' behaviour, and on how successful the Tax Office is in countering it.

Evasion will be easier because of the fundamental nature of Zero/Ten. At the moment the Tax Office has two levels at which it can collect tax for Jersey residents – first it taxes the company on its profits, and if it fails to do that it can tax the shareholder at the same rate. However under Zero/Ten companies are to be tax-free (except for finance service providers and utilities), so there will be only one opportunity to collect tax – from the shareholder. This makes evasion easier, because there is only one level of tax that needs to be evaded rather than two.

The ownership of Jersey companies could be disguised by having their shares owned by a trust or an offshore company. For example, a Jersey resident shareholder could set up a Guernsey or Cayman Islands company, and sell his shares to it. The Jersey resident would have a legal obligation to declare his indirect ownership of the shares, and pay tax on his share of the Jersey company's profits[5], but if he did not then it might be difficult for the Comptroller to obtain the necessary proof to prosecute (because he has no authority to obtain shareholder information from off-Island entities[6]).

Of course the Tax Office will be suspicious if numerous Jersey companies are suddenly taken over by unknown Cayman companies once Zero/Ten is introduced. However, we have already seen several prominent Jersey companies being taken over by offshore groups, and it might be difficult for the Tax Office to distinguish between genuine take-overs and those who are merely hiding their ownership behind an offshore structure.

For newly-formed companies it will be even easier to disguise ownership in this way, since there is no current ownership to hide.

[5] Art.4 of the new law provides that shareholders will be taxed even if they only own shares via companies, or trusts, or both, provided there is a Jersey company at the bottom of the structure. However there remains the practical problem of discovering this indirect ownership.
[6] The problems are even greater in the case of discretionary trusts, where there may not be any formal right for anyone to receive the trust's income.

6. Tax avoidance

Under Zero/Ten it would be possible to avoid having a Jersey company at all. A Jersey business could be owned and run directly by an off-Island (e.g. Guernsey) company, owned by Jersey residents.

Those Jersey residents will have a legal duty to disclose their shareholding (although if they do not it could be difficult for the Tax Office to prove it; see section on ‘Tax evasion’). However even if they do, the deemed distribution rules will not apply where there is no Jersey-resident company. Instead the Comptroller of Income Tax will have to rely on the general anti-avoidance rule (Art134A of the existing Income Tax law). This is more difficult for the Comptroller to use than the deemed distribution rule, because it sets an extra hurdle that the taxpayer must have a tax avoidance motive for what he does.

Again, this will be more difficult to arrange for an existing Jersey business (and easier for the Comptroller to attack under Art134A), but for a new business it could be difficult for the Comptroller to challenge the taxpayer’s decision to incorporate in Guernsey (especially if the business is to operate on both Islands).

7. Investment distortion

Even if there is no deliberate tax avoidance motive, it would still be more advantageous for a Jersey resident to invest in off-Island companies, because he would only be taxed when he actually receives a dividend[7] rather than annually on deemed dividends. Obviously there are many reasons for choosing an investment, but this will certainly be a factor and could weaken on-Island investment.

Conversely, off-Island investors could have an advantage when bidding for a Jersey company. If a Jersey company is owned by a non-Jersey individual, then there will be no tax on the profits of the business until the company actually pays a dividend. This will allow the company to reinvest all its profits tax-free, giving it a financial advantage over its locally owned rivals. However if the company is owned by Jersey resident shareholders they will be taxed on deemed dividends, which will put pressure on the company to pay a dividend (so that the shareholders can pay the tax) and therefore leave it with less money to reinvest.

Obviously this will depend on the reinvestment policy of the company. Jersey resident shareholders will only be taxed on 60% of the profits of a trading company, so the company will have an absolute minimum of 40% to reinvest. This may mean that in many cases it would be less advantageous to the off-Island investor. However for rapidly expanding companies that need significant reinvestment it could be significant.

Another factor is the off-Island shareholder's home tax system. For a UK investor there are significant UK tax advantages in owning a tax-free Jersey trading company[8]. This is likely to apply to investors from other countries as well.

In economic terms, these two factors could cancel each other out. Even if Jersey investors will become more likely to invest off-Island, as off-Island investors become increasingly attracted to Jersey trading companies they may make up that lost investment. However there remains a social policy issue if there is a decline in Jersey-owned Jersey-operating businesses.

[7] If there is no tax avoidance motive he will not be caught by Art134A

[8] He will be able to reinvest the profits free of tax, either in Jersey or around the world, and provided the majority of the company's activities remain in Jersey that may help him to escape the UK's anti-avoidance laws.

The Panel is concerned that Zero/Ten will increase the need to monitor non-resident trading companies. With the move to Zero/Ten, non-finance trading companies owned by non-residents will not be contributing to the Island's tax take, and may be employing large numbers of immigrant staff, many of whom may also not be paying tax, and will ultimately have access to the Island's social and other facilities. This is an issue which will be considered by the Migration Scrutiny Sub-Panel, however the Panel strongly feels that a detailed assessment by the Economic Development Department, of the long-term net worth to Jersey of these off-shore owned businesses would be beneficial.

8. Taxing Foreign Owned Trading Companies

Unfortunately, because of Jersey's commitment to comply with the EU Code of Conduct on Business Taxation under Zero/Ten we can only tax shareholders if they are tax-resident in Jersey. This means that companies that are not owned by Jersey people will not pay income tax here, even if they carry out business in Jersey (most obviously many of the Island's High-Street shops, which are owned by UK companies). The Panel believes this puts Jersey-owned businesses at an unfair disadvantage, and therefore has been investigating potential ways of collecting at least some tax from these companies.

The Panel's recent report[9] examined this issue and put forward a partial solution that was proposed by Jurat Peter Blampied for a tax on owner-occupied business property. The Minister for Treasury and Resources has subsequently agreed to examine this proposal closely, including the economic impact and potential yield from this tax. However, the Panel's report was presented on the 4th September, meaning that by the time the debate on the draft shareholder legislation takes place on the 20th November, some eleven weeks will have passed since its presentation. We are also mindful that this proposal was first highlighted to the Minister in our initial report on the Zero/Ten proposals, which was presented to the States on the 28th September 2006.[10]

We are concerned that so much time has passed since this proposal was initially put forward, and urge the Minister to examine the economic impact and potential yield, and report on his findings, as a matter of urgency.

[9] S.R.14/2007
[10] S.R.4/2006 Section 5.5.3 (b)

9. Comptroller's powers (Article 20b)

As Guernsey also moves to Zero/Ten, with no disclosure of shareholder registers, the ability of Jersey residents to hide their incomes offshore will increase. To attempt to solve the problems of the Comptroller's lack of information, the draft legislation therefore gives the Comptroller extensive powers to obtain information, from individuals, companies and company secretaries. This includes details of all potential sources of income, whether or not any income is actually obtained from them. Unless handled sensitively this could fundamentally change the relationship between the taxpayer and the Tax Office, and by creating a more adversarial atmosphere could reduce voluntary compliance and increase tax avoidance and evasion.

The UK model differs from Jersey's proposals. Under the UK system many of the more intrusive powers can only be used when a taxpayer is under formal investigation, and it would be possible to appeal to the Commissioners if the investigation is dragging on with no evidence of wrongdoing.

The Comptroller for Income Tax explained that the UK legislation had been considered, and that is the model that has been adopted by Guernsey and the Isle of Man, however this method had not been proposed for Jersey as it was his understanding that Guernsey professionals believed the Island had gone too far in this area.[11]

The Panel accepts the proposal to increase the Comptroller's powers but warns that a sensitive approach will be required if the Comptroller is to avoid a counter productive non-cooperative backlash from law abiding tax payers.

[11] Transcript, p.37

10. Exemption from deemed distribution for quoted companies

Under the draft legislation, shareholders in companies quoted on a “recognised stock exchange” are exempt from deemed distribution **(Art38, inserting new Art81B(1))**. This is not just the London Stock Exchange, but includes several smaller exchanges, on which it could be relatively cheap and simple for a company to become listed. Jersey residents who own shares in those companies will not pay any tax until they actually receive a dividend – giving them an advantage over shareholders in unquoted companies.

We accept that it would be administratively impossible to apply the deemed distribution rule to a holding of a few shares in Shell or IBM. However:

- Deemed distribution only applies to Jersey companies; and
- There is a 5% de minimis, so a shareholder who holds less than 5% of the company’s shares will not be subject to look-through anyway.

The Panel can see no reason why someone who owns more than 5% (or even 2%) of a quoted company should not pay tax on its profits, when a shareholder in a small unquoted company will do so.

Secondly, there is a risk that some companies will seek to become listed on a small low-cost stock exchange specifically in order to avoid the deemed distribution tax and thereby be able to reinvest their profits tax-free, a tax break denied to normal Jersey companies.

This exemption therefore seems to be unnecessary, and risks increasing avoidance further, and we therefore have lodged an amendment to remove this exemption.

11. De minimis limit

Under the lodged legislation, the deemed distribution and look-through proposals will not apply to shareholders who own 5% or less of the shares in the company. Although the Panel accepts the administrative need for a de minimis, it feels that 5% is too high, for the following two reasons:

- Firstly, 5% of a company can be a significant investment;
- Secondly, it would be possible to avoid tax on a significant proportion of a company's profits by splitting shareholdings between family members, each holding just 5% of the shares.

This de minimis would enable some significant shareholdings to avoid tax (until a dividend is actually paid), an ability denied to many owners of small companies.

The Panel therefore believes that 2% would be a better compromise between administrative efficiency and fairness, and have therefore lodged an amendment accordingly.

12. Other issues

The distinction between a trading company (subject to 60% deemed distribution) and an investment company (subject to 100% look-through) now appears to be satisfactory. **The Panel is pleased that the Treasury have abandoned their original definition, which was criticised in our report[12], in return for a more practical basis.**

Deemed distributions were to be calculated on an "accounts profit" basis; however the draft legislation has switched this back to a "tax profits" basis (which goes against the principle of deemed distribution). The Comptroller explained to the Panel that this alteration was made because it was felt there were too many loopholes in the general accepted accounting principles route, because clever accountants would put through provisions and other expenses that would reduce the profits chargeable under the distribution basis. It was therefore believed that this option was tighter and more able to prevent avoidance. The Panel also received evidence from local accountants that indicated that many smaller Jersey companies would find it difficult to apply full accounting standards to their accounts. **The Panel supports this decision, although has not had sufficient time to investigate the possibility of a challenge under the Human Rights Law.**

Shareholder loans are exempt from being taxed as distributions if the company charges the shareholder a commercial interest rate. The Panel is concerned that this gives scope for tax avoidance, as the company could make further loans to its shareholders to enable them to 'pay' interest. After having considered this issue, the Panel accepts that attempting to amend the legislation to prevent this avoidance might also catch genuinely commercial loans. The Panel notes that Article 134A of the Income Tax legislation should provide the Comptroller with the appropriate powers to ensure this exemption is not taken advantage of. **However this situation will need to be monitored.**

[12] S.R.3/2007