Review of Personal Tax
Work stream 3 – paper outlining legal and policy considerations around the (dis)incentivisation of profit retention

Background

1. The majority of Jersey resident companies are subject to corporate income tax at 0% (**"0% Companies"**).

2. The existence of "0% Companies" together with a 20% rate of personal income tax creates two broad incentives amongst Jersey resident individuals:

   - Incentive 1: there is an incentive to incorporate trading and investment activities, provided the individual is in a financial situation to distribute less than the annual trading profits/investment income accruing in the company

   - Incentive 2: for those whose trading/investment activities have been incorporated, provided that they are in a financial situation to do so, there is an incentive to distribute less than the annual trading profits/investment income accruing in the company

3. From the introduction of "0% Companies" until 31 December 2011 these incentives were reduced through the application of the "deemed dividend" and "full attribution" rules.

4. The "deemed dividend" rules applied in the context of trading companies[1]. Broadly they meant that any Jersey resident individual shareholder would be treated (deemed) as having received a dividend of 60% of their share of the taxable profits of the 0% trading company, on which they would pay income tax personally. The amount deemed could be reduced by paying actual, taxable dividends to the shareholder within a specified time period.

5. As a consequence of the "deemed dividend" rules "0% Companies" could be used to defer 60% of trading profits for a short-period (depending on factors such as company accounting dates) and a maximum of 40% of taxable profits for a longer-period of time. For the avoidance of doubt, under the "deemed dividend" rules tax could only ever be deferred to a later date; as any untaxed profits would eventually be taxable on the earliest of one of a number of "trigger events".

6. The "full attribution" rules applied in the context of investment holding companies[2]. Broadly they meant that where a Jersey resident individual held shares in a 0% investment company, for tax purposes the individual was treated as receiving their share of the income arising in the company directly. For example, Mr X owned 100% of the shares in Jersey Co Ltd (an investment company); Jersey Co Ltd owns shares in ABC Plc on which a dividend is paid. Under the full attribution rules Mr X had to include that ABC Plc dividend income in his personal tax return and pay tax on it as if it had arisen to him directly.

7. As a consequence of the "full attribution" rules an individual could only defer investment income for a short-period (depending on factors such as company accounting dates).

[1] The term "trading company" is defined in paragraph 2 to Schedule A1 of the Income Tax (Jersey) Law 1961.
[2] Defined as companies other than "trading companies" and collective investment funds. The full attribution rules also specifically applied to personal services companies.

8. In 2010 these rules (both the "deemed dividend" and "full attribution" rules) were found to be harmful by the EU under the Code of Conduct for Business Taxation and, under the good neighbour policy, a decision was taken that the rules should be repealed. They were repealed with effect from 31 December 2011.

9. With effect from 1 January 2013 rules have been introduced which: (i) broaden the definition of "distribution"; and (ii) ensure that the distributions made by "0% Companies" are matched first and foremost against any profits arising in the company and subject to tax at 0%[3]. These rules seek to prevent "0% Companies" from being used for the avoidance or inappropriate deferral of Jersey income tax by Jersey resident individual shareholders[4].

10. However Jersey resident individual shareholders in "0% Companies" are only subject tax when they receive a distribution. Where no distribution is made, there is no taxable amount for the Jersey resident individual shareholder to declare on their personal income tax return.

11. Therefore the two incentives outlined in paragraph 2 above continue to exist as at the date of this paper.

12. Both the incentives identified above primarily result in deferral of tax (i.e. the individual does not pay tax on the trading profits/investment income in the year they accrue, but in a later year when they are distributed). However it is acknowledged that:

    - the period of this deferral is uncertain and will be determined in each case by the financial position and choices made by the "0% Company"/Jersey resident individual shareholder; and

    - if distributions are deferred until a Year of Assessment in which the individual recipient is not subject to income tax in Jersey (e.g. they have emigrated from the Island), Jersey tax on those trading profits/investment income will not be payable

International comparison

13. Jersey is not unusual in maintaining a corporate income tax rate which is lower than the rate of personal income tax. Appendix A compares the top rate of personal income tax with the standard rate of corporate income tax for each of the OECD countries. This analysis shows that in all but 4 OECD countries[5] the standard corporate income tax rate is lower than the top rate of personal income tax[6] – hence the tax systems in the remaining 31 OECD countries *prima facie* create the same incentives as are created in Jersey.

14. The largest differential between the top rate of personal income tax and the standard corporate income tax rate is 33% in Slovenia.

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[3] Under this matching concept any distribution is treated first and foremost as having been made out of any profits subject to tax at 0% in the company. Therefore, to the extent that such profits exist, distributions will be fully taxable on any Jersey resident individual recipient.

[4] Furthermore the intermediary services vehicle ("ISV") rules were introduced with effect from 1 January 2013 to prevent any tax advantage accruing through the use of personal services companies. Up to 31 December 2011 such arrangements had been taxed under the "full attribution" rules.

[5] Per the analysis in Appendix A the Czech Republic, Spain and Switzerland have a higher standard rate of corporate income tax than the top rate of personal income tax, whilst in Estonia the standard rate of corporate income tax and the top rate of personal income tax are the same.

[6] It is further noted that the analysis in Appendix A only captures the central/federal personal tax rates charged; the highest personal tax rate actually suffered may be increased by state/local personal income taxes.

15. Another 5 countries (including the UK[7]) have larger differentials between the top rate of personal income tax and the standard corporate income tax rate than the 20% differential existing in Jersey.

UK differential and anti-avoidance legislation

16. From 1922 onwards the UK has maintained some form of anti-avoidance legislation designed to prevent shareholders from obtaining a tax advantage through the retention of profits in a closely-controlled company[8] rather than distributing those profits.

17. From 1965 to 1989 that legislation took the form of apportionment to shareholders of a shortfall in distributions (e.g. similar in nature to the "deemed dividend"/"full attribution" rules applicable previously in Jersey). The impact of that legislation was significantly reduced in 1980 with the exclusion of trading income from apportionment. The apportionment provisions were then abolished altogether in 1989.

18. In place of the apportionment provisions, much more limited anti-avoidance legislation targeting "close investment-holding companies" was introduced.

19. There is no requirement for close investment-holding companies to distribute all or any of their income and the only consequence where a company is a close investment-holding company is that the small profits rate of corporation tax is not available to such a company; furthermore from 1 April 2015 this restriction is academic as there is only one rate of UK corporation tax for all companies.

20. Hence despite the significant differential between the top rate of personal income tax and the standard corporate income tax rate in the UK, since 2015 there is no anti-avoidance legislation that applies to prevent the retention of profits in closely-controlled companies.

Tax incentives offered in other jurisdictions

21. A number of jurisdictions offer specific tax incentives in order to encourage companies to reinvest profits rather than distribute them to their shareholders (i.e. they actively encourage the retention of profits within corporate structures). This is ordinarily achieved in one of two ways:

    - The tax liability of the company itself is reduced by allowing a deduction for the amount reinvested (or a proportion thereof) from the profits otherwise taxable[9]; or

    - The shareholder, or parent company, is given a refund of the tax paid by the local enterprise up to a stated proportion of the amount reinvested; allowing the refunded tax to be reinvested either in the original company that made the profits or in some other qualifying company[10]

22. These incentives are ordinarily available in the context of trading companies, rather than investment companies.

[7] The UK has already announced its intention to reduce the standard rate of UK corporate income tax to 17% by 1st April 2020.
[8] A company held by a small number of shareholders.
[9] Offered for example in Malaysia and Romania.
[10] As have been offered for example in China.

23. Other jurisdictions have at times used “split-rate systems” to incentivise the retention or the distribution of profits by companies. In a split-rate system different corporate income tax rates are applied depending on whether profits are retained or distributed.

24. A split-rate system was utilised by the UK in the period immediately after World War II to encourage the formation of capital within the corporate sector and restrain personal consumption by disincentivising distributions by charging a significantly higher tax rate on distributed profits than on retained profits. France utilised a split-rate system for a similar purpose between 1989 and 1991.

25. Conversely a split-rate system was utilised by Germany until relatively recently which sought to encourage the distribution of profits through charging a lower corporate income tax rate on distributed profits than on retained profits.

26. Malta has a unique tax system. Companies in Malta are subject to corporate income tax at 35%. However Malta offers (subject to certain conditions) tax refunds on distributed profits which have suffered tax in Malta. In order to qualify for a refund, the profits must be distributed either to non-resident shareholders or to a Maltese holding company wholly owned by non-residents.

27. The rates of the tax refund are: 6/7 of the Maltese tax paid on the distributed profits (effective tax rate in Malta is only 5% in this case); 5/7 of the Maltese tax paid when the dividend is distributed from passive interest or royalties; 2/3 of the Maltese tax paid when the distributed dividend is derived from foreign sourced income that was relieved from double taxation. In the context of non-resident shareholders the Maltese tax system therefore incentives the distribution of profits.

Interaction of corporate income tax and personal income tax

28. Depending on the taxation of distributions from companies (in particular whether a tax credit is available to the individual recipient for the underlying corporate income tax paid by the company) a jurisdiction’s overall tax system may discourage: (i) the incorporation of activities, and (ii) the distribution of corporate profits, because the final overall effective tax rate suffered by the individual recipient may be higher than if they had carried on those activities personally (i.e. not through a corporate structure). This is the case in a number of jurisdictions which operate what is known as a “classical tax system” which gives no credit for the underlying corporate income tax paid.

29. The United States and the Netherlands have a “classical tax system” in which dividend income is taxed at the shareholder’s full marginal personal tax rate. Other countries, including Australia, have an ‘imputation system’, in which there is an explicit tax credit against personal income tax on dividend income in recognition of tax paid on the underlying profits at the corporate level. Many EU countries, including the UK, tax dividend income at lower personal tax rates than other sources of income.

Conclusion

30. This international comparison indicates:

- Jersey, in common with most OECD jurisdictions, maintains a standard corporate tax rate that is lower than the top rate of personal income tax.

- There is no globally accepted approach as to whether tax systems should encourage the retention of profits within companies or alternatively encourage the distribution of profits to shareholders. Different jurisdictions have adopted different approaches at different times depending on the specific policy considerations applicable at that time. Different jurisdictions may also adopt a different approach to trading companies than they adopt to investment companies; particularly closely-controlled investment companies.

- Despite the larger differential in the UK between the top rate of personal income tax and the standard corporate income tax rate, since 1 April 2015 there are no anti-avoidance rules operating in the UK to prevent the retention of profits in companies.

Policy considerations

Non-Jersey specific considerations

31. In determining a jurisdiction's corporate income tax rate, policy makers are balancing a number of competing objectives including (but not limited to):

    - raising the required amount of revenue to fund the provision of public services in the jurisdiction;

    - raising that required amount of revenue from the available taxation sources in the jurisdiction;

    - supporting the economy; and

    - maintaining the integrity of the overall tax system (i.e. not providing opportunities for taxpayers to reduce their liabilities)

32. When determining corporate income tax rates the high-level advice from global institutions/leading economic institutes to policy makers is that corporate income taxes are harmful to economic growth.

33. For example the OECD have stated: "Corporate income taxes are the most harmful for growth as they discourage the activities of firms that are most important for growth: investment in capital and productivity improvements. In addition, most corporate tax systems have a large number of provisions that create tax advantages for specific activities, typically drawing resources away from the sectors in which they can make the greatest contribution to growth."[11]

34. The European Commission have recently stated: "Literature suggests that corporate and personal income tax have a strong negative impact on growth while consumption taxes, in particular recurrent taxes on immovable property, are found to be less harmful to growth."[12]

[11] See http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/tax-policy-reform-and-economic-growth/growth-oriented-tax-policy-reform-recommendations_9789264091085-3-en#page8

[12] See Tax Policies in the European Union - 2016 Survey (https://ec.europa.eu/taxation_customs/business/company-tax/tax-good-governance/eu-semester/tax-policies-european-union-2016-survey_en)

35. Whilst a report of the Institute of Fiscal Studies has stated: “There are two key results in the economic literature on taxation in small open economies that may be helpful in understanding recent developments in corporate income taxation, as the world economy in general, and financial markets in particular, have become more integrated. The first states that source-based taxes on income from capital levied by a small open economy are not borne by the owners of capital, but are fully shifted onto relatively immobile workers. The second states that it is inefficient to impose source-based taxes on income from capital in small open economies.”[13]

36. The Institute of Fiscal Studies report concludes: “…it is clear that there is a powerful force towards lower corporate tax rates applying in open economies that is not present in closed economies, and it is no surprise that corporate tax rates should have fallen as economies have become more open to trade and capital flows, and as capital markets have become more integrated. There is a coherent argument that countries will do better by complying with these forces than by trying to resist them.”

37. Consistent with this conclusion over the recent past corporate income tax rates across the globe have generally reduced. Appendix B outlines analysis showing the standard corporate tax rates in the OECD countries in 2000, 2008 and 2015. Of the 34 OECD countries listed[14], 1 country had the same corporate income tax rate in 2000 and 2015; 2 countries had increased their corporate income tax rate between 2000 and 2015 and the remaining 31 countries had reduced their corporate income tax rate.

38. It is also of note that the period covered by the analysis included the financial crisis and the pressure on public finances that the crisis caused in many OECD countries.

39. However the advice to cut corporate income tax rates is caveated by the need to maintain the integrity of the overall tax system.

40. For example the OECD have stated: “However, lowering the corporate tax rate substantially below the top personal income tax rate can jeopardize the integrity of the tax system as high-income individuals will attempt to shelter their savings within corporations.”[15]

41. The authors of the Mirrlees Review stated: “More generally, the form and structure of the corporate income tax should be consistent with the form and structure of the personal income tax, and with policy choices for the taxation of savings in particular. The system as a whole should not present individuals with glaring opportunities to avoid taxation of their income from savings simply by holding their wealth in corporate form, nor should it penalize individuals who choose to save and invest through direct holdings of company shares.”[16]

42. We can find no evidence in the literature reviewed of a recommended or ideal corporate distribution ratio (i.e. the amount of corporate profits that should be distributed to

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[13] See Corporate Income Taxes and Investment: A Comparative Study (https://www.ifs.org.uk/docs/bertlesmann.pdf)

[14] This analysis was produced by the OECD in advance of Latvia becoming a full member of the OECD, explaining why the analysis in Appendix A covers 35 countries whilst the analysis in Appendix B only covers 34 countries.

[15] See http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/tax-policy-reform-and-economic-growth/growth-oriented-tax-policy-reform-recommendations_9789264091085-3-en#page8

[16] See Taxing Corporate Income Chapter 17 of Tax by Design (final report from the Mirrlees Review) (https://www.ifs.org.uk/uploads/mirrleesreview/design/ch17.pdf)

shareholders on an annual basis); the literature reviewed is silent on this issue. Correspondingly, as noted above in the international comparison section of this paper, different jurisdictions have incentivised the distribution or the retention of corporate profits at different points in time.

Jersey specific considerations

43. In determining the Island's standard corporate income tax rate, policy makers have been strongly influenced by the need for the corporate income tax regime to support the Island's economy.

44. In order to support the Island's economy, Jersey needs to offer tax neutral corporate vehicles in an internationally compliant manner. The zero/ten regime delivers that offering in a simple, transparent way and has been found to be internationally compliant.

45. Jersey's corporate tax regime prior to the zero/ten regime, broadly consisting of taxable companies where there was local ownership and exempt companies where there was non-local ownership (positively discriminating in favour of non-residents), although better at maintaining the integrity of the domestic tax system was found to be "harmful" by the EU. The implications for the Island of maintaining a "harmful" regime were such that policy makers determined that a change to the zero/ten regime was in the best interests of the Island.

46. On the introduction of the zero/ten regime policy makers were aware of both the change in the burden of taxation (i.e. the shift from corporate taxation to personal taxation) and the challenge it would pose to the integrity of the overall tax system. To help address the challenge to the integrity of the overall tax system the "deemed dividend" and "full attribution" rules were introduced in partnership with the zero/ten regime.

47. However when these rules were subsequently found to be "harmful" by the EU, policy makers determined that maintaining the zero/ten regime without the "deemed dividend" and "full attribution" rules was the best course of action irrespective of the challenge to the integrity of the overall tax system this created.

48. Subsequent to the removal of the "deemed dividend" and "full attribution" rules, policy makers have introduced the "distribution rules" to minimise the opportunity for avoidance and inappropriate deferral on personal income tax.

49. In determining whether any further steps can be taken to improve the integrity of the overall tax system, policy makers are acutely aware of the need to maintain the availability of tax neutral corporate vehicles in an internationally compliant manner.

50. It is of note that both Guernsey and the Isle of Man have adopted similar policy responses, initially implementing measures that sought to maintain the integrity of the overall tax system but removing, and not directly replacing, them when those measures were subsequently found to be "harmful".

Legal considerations

51. Under Art 134A of the Income Tax (Jersey) Law 1961[17] the Comptroller of Taxes has the power to make assessments/additional assessments he considers appropriate to prevent the avoidance or reduction of Jersey income tax.

52. Although each case depends on its own facts (and hence this cannot be treated as a form of general clearance) the Comptroller of Taxes would not ordinarily seek to raise an assessment/additional assessment under Art 134A where a Jersey resident individual incorporates a Jersey resident company; nor where a Jersey resident company defers the distribution of profits to a Jersey resident individual shareholder.

[17] Article 134A has been reproduced in Appendix C.

Appendix A
Comparison of corporate income tax rates and personal income tax rates – OECD countries

Table 1 – personal and corporate tax rates in OECD countries[18]

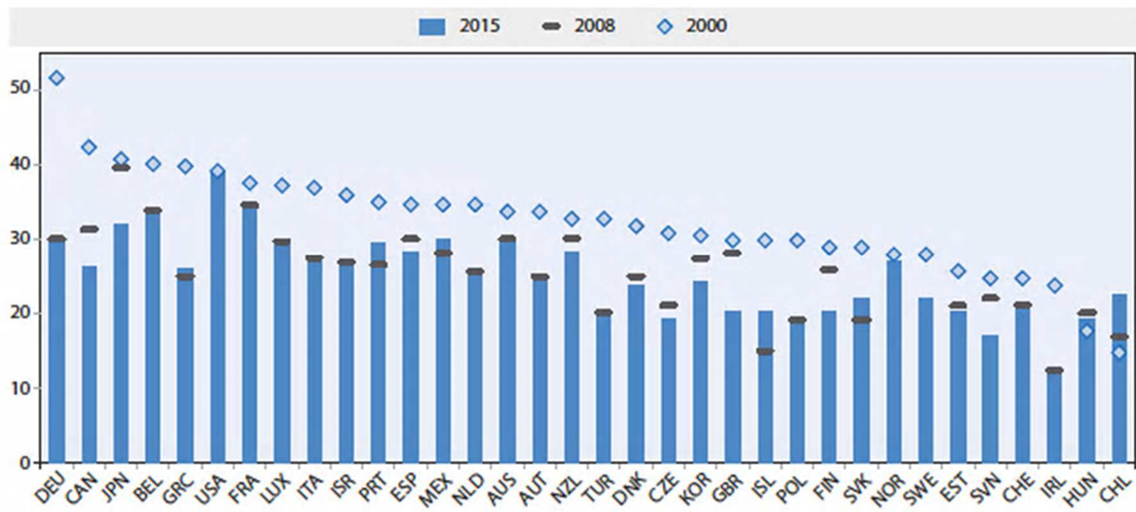
Country	Top rate personal income tax	Standard corporate income tax rate	Differential
Australia	45.00%	30.00%	15.00%
Austria	50.00%	25.00%	25.00%
Belgium	50.00%	33.99%	16.01%
Canada	29.00%	26.80%	2.20%
Chile	40.00%	24.00%	16.00%
Czech Republic	15.00%	19.00%	(4.00%)
Denmark	23.08%	22.00%	1.08%
Estonia	20.00%	20.00%	Nil
Finland	31.75%	20.00%	11.75%
France	45.00%	34.43%	10.57%
Germany	45.00%	30.18%	14.82%
Greece	42.00%	29.00%	13.00%
Hungary	16.00%	19.00%	3.00%
Iceland	31.80%	20.00%	11.80%
Ireland	40.00%	12.50%	27.50%
Israel	50.00%	25.00%	25.00%
Italy	43.00%	31.29%	11.71%
Japan	45.00%	29.97%	15.03%
Korea	38.00%	24.20%	13.80%
Latvia	23.00%	15.00%	8.00%
Luxembourg	40.00%	29.22%	10.78%
Mexico	35.00%	30.00%	5.00%
Netherlands	52.00%	25.00%	27.00%
New Zealand	33.00%	28.00%	5.00%
Norway	25.15%	25.00%	0.15%
Poland	32.00%	19.00%	13.00%
Portugal	48.00%	29.50%	18.50%
Slovak Republic	25.00%	22.00%	3.00%
Slovenia	50.00%	17.00%	33.00%
Spain	22.50%	25.00%	(2.50%)
Sweden	25.00%	22.00%	3.00%
Switzerland	13.20%	21.15%	(7.95%)
Turkey	35.00%	20.00%	15.00%
United Kingdom	45.00%	20.00%	25.00%
United States	39.60%	38.92%	0.68%

Source: OECD.Stats: Personal tax rates extracted from Table I.1. Central government personal income tax rates and thresholds; Corporate tax rates extracted from Table II.1 Corporate income tax rates (extracted February 2017)

[18] Only includes central/federal tax rates; the tax rate actually suffered may be increased by state/local personal/corporate income taxes.

Appendix B
Trends in global corporate tax rates – OECD analysis

<u>Graph 1 – OECD corporate income tax rates (%) since 2000</u>



Source: Tax Policy Reforms in the OECD 2016 [19]

[19] See: http://www.oecd-ilibrary.org/taxation/tax-policy-reform-in-the-oecd-2016_9789264260399-en

Appendix C
Article 134A of the Income Tax (Jersey) Law 1961

134A Power of Comptroller to make assessment to prevent avoidance of income tax[634]

(1) If the Comptroller is of the opinion that the main purpose, or one of the main purposes, of a transaction, or a combination or series of transactions, is the avoidance, or reduction, of the liability of any person to income tax, the Comptroller may, subject as hereinafter provided, make such assessment or additional assessment on that person as the Comptroller considers appropriate to counteract such avoidance or reduction of liability:

Provided that no assessment or additional assessment shall be made under this Article if the person shows to the satisfaction of the Comptroller either –

(a) that the purpose of avoiding or reducing liability to income tax was not the main purpose or one of the main purposes for which the transaction, or the combination or series of transactions was effected; or

(b) that the transaction was a bona fide commercial transaction, or that the combination or series of transactions was a bona fide combination or series of transactions and was not designed for the purpose of avoiding or reducing liability to income tax.[635]

(2) The provisions of this Law shall apply to any assessment or additional assessment made under this Article as if it had been made in pursuance of Part 5.

(3) Without prejudice to the generality of paragraph (2), any person who is aggrieved by any assessment or additional assessment made on the person under this Article shall be entitled to appeal to the Commissioners on the ground that –

(a) the avoidance, or reduction, of the liability of that person to income tax was not the main purpose, or one of the main purposes, of the transaction, or the combination or series of transactions;

(b) the transaction was a bona fide commercial transaction, or that the combination or series of transactions was a bona fide combination or series of transactions and was not designed for the purpose of avoiding or reducing liability to income tax; or

(c) that the person has been overcharged by the assessment or additional assessment,

and all the provisions of this Law relating to appeals against any assessment shall apply to any appeal made under this Article