ZERO/TEN CORPORATE TAX REGIME

BACKGROUND INFORMATION

1. In the responses to questions in the States Assembly on Friday 10 December, 2010 on the position taken by the EU Code of Conduct Group, ECOFIN and the United Kingdom HM Treasury regarding the zero/ten corporate tax regime, the Chief Minister undertook to provide Members with a full position statement on zero/ten.

What is the Code of Conduct on business taxation?

2. In December 1997 the EU ECOFIN Council resolved to establish a Group, within the framework of the Council, to assess the tax measures that may fall within a Code of Conduct for business taxation. The Council confirmed the establishment of a Code of Conduct Group on the 9 March 1998.

3. The ECOFIN Council in adopting the Code of Conduct in its application to Member States also committed Member States with dependent or associated territories, within the framework of their constitutional arrangements, to ensuring that the principles of the Code are applied to those territories. At the end of 1998 the UK submitted a report on the application of the principles of the Code in respect of the dependent territories. In 1999 the Code of Conduct Group considered a list of potentially harmful tax measures, including those for the dependent territories, according to the scope and coverage of the Code of Conduct and the following criteria on which the Group bases its assessment of tax measures:-

A. *Without prejudice to the respective spheres of competence of the Member States and the Community, this Code of Conduct, which covers business taxation, concerns those measures which affect, or may*

affect, in a significant way the location of business activity in the Community.

Business activity in this respect also includes all activities carried out within a group of companies.

The tax measures covered by the Code include both laws or regulations and administrative practices.

B. *Within the scope specified in paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this Code.*

Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any other relevant factor.

When assessing whether such measures are harmful, account should be taken of inter alia:

1. *Whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents; or*

2. *Whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base; or*

3. *Whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages; or*

4. *Whether the rules for profit determination in respect of activities within a multinational group of companies departs*

from internationally accepted principles, notably the rules agreed upon within the OECD; or

5. *Whether the tax measures lack transparency, including where legal provisions are relax*ed *at administrative level in a non-transparent way.*

4. The Code also includes the following which could be of relevance to the Island –

"Insofar as the tax measures are used to support the economic development of particular regions, an assessment will be made of whether the measures are in proportion to, and targeted at, the aims sought. In assessing this, particular attention will be paid to special features and constraints in the case of the outermost regions and small islands, without undermining the integrity and coherence of the Community legal order, including the internal market and common policies."

It is understood however that it is standard Code practice that in such cases the regime at stake should be excluded for certain highly mobile intra group activities which do not create true economic activity in substance and which, instead, mainly attract a mobile tax base via the erosion of the tax base of the Member States.

5. The Code criteria have not changed since their initial application to Jersey's tax measures in 1999, and it is against these criteria that the zero/ten corporate tax regime as a whole has been evaluated by the European Commission ('the Commission') and by the Code Group. The only reference to the level of taxation is in paragraph B of the Code criteria. There it is not the level of tax as such that is in question but whether tax measures provide a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question.

6. The Commission's view is that while the general corporate tax rate for Jersey companies seems to be zero per cent, special higher rates apply to licensed banks, to utility companies and to real estate income. In addition, it is of the view that, through a combination of the 0/10 system with the deemed distribution and attribution provisions for resident individuals, an effective 0% rate for Jersey business profits is not available to the extent that a Jersey company has resident shareholders holding a share interest of 2% or more. In that case these shareholders will not only be taxed on the actual distributed profits but also the undistributed business profits for the Jersey company will be taxed in the hands of the shareholder at a minimum of 12% (20% of 60%) for trading companies and 20% (20% of 100%) for investment companies. Consequently, the European Commission ("the Commission") was of the view that the general effective tax rate for business profits realised by Jersey companies is difficult to determine, but that it is not 0%. This Commission view, which was contested by the Jersey authorities, was based on their following analysis -

- *it is 10% for licensed financial service companies;*
- *it is 20% for certain specified utility companies;*
- *it is 20% for rental income of property development profits from Jersey property;*
- *it is a minimum of 12% for trading companies to the extent that it has Jersey shareholders holding a share interest of 2% or more, and;*
- *it is 20% for all other companies with Jersey shareholders.*

The Commission's view is that, formally, the deemed distribution and attribution provisions are applied at individual level and could therefore be regarded as outside the scope of the Code of Conduct. However the fact that these provisions effectively ensure taxation of business profits of all Jersey corporate tax payers with Jersey shareholders made the Commission believe this provision was inside

the scope of the Code of Conduct for business taxation, a view contested by the Jersey authorities. Moreover, the Commission's view was that these provisions could not be compared to deemed distribution or attribution rules in other Member States as such rules are typically limited to various specific fact patterns. On that basis the Commission considered that an effective Jersey tax of 0% for Jerseys sourced business profits provides for a significantly lower level of taxation than those levels which generally apply in Jersey. As a result the Commission concluded that there was discrimination between the tax position of non-resident shareholders and that of Jersey shareholders in a Jersey company.

Why is Jersey covered by the Code?

7. The question may be asked why, as Jersey is not a member of the European Union and fiscal matters are not within the scope of Protocol 3 attached to the Treaty of Accession of the United Kingdom to the European Union which establishes the scope of the formal relationship between Jersey and the European Union, does the Code of Conduct apply to Jersey.

8. Jersey made a voluntary commitment to abide by the Code in 2002, and the President of the Policy and Resources Committee, Senator Pierre Horsfall, made a statement to the States on the 19 November 2002. To quote from that statement –

"After the most careful analysis, the Policy and Resources Committee, working with the Finance and Economics Committee has concluded that we can accommodate the Code principles in the form of a move – over time – towards a zero rate of tax for companies generally with a different, higher rate applying to financial services companies with certain other special groups such as public utilities. We would thus be able to continue to ensure that exempt companies are "exempt" or tax neutral but in a non-discriminatory

manner. At the same time we would manage the eventual transition of those service providers with IBC status into line with this general regime."

………. "I should now like to turn to the additional subject matter of this statement, which as I have said is the important question of the general competitiveness of the Island for financial services business in world markets. Notwithstanding the difficulties that it has itself created for us, we must recognise that the Tax Package has also been the driver of a general move among non-EU jurisdictions towards the contemplation of zero business tax structures together with special higher rates for the financial services industry. Gibraltar and the Isle of Man are examples, both having recently announced their intention to move in this direction by 2006 with an aim to achieve an effective rate of tax on the profits of financial services of around 10%. Moreover, other significant jurisdictions with which we compete for global business such as Cayman, the Bahamas and Bermuda, already have zero tax regimes on all business including that of financial services providers. In setting our future strategy, we simply cannot afford to ignore such competition if we are to retain the service providers who currently do business in Jersey and which provide such a large proportion of our tax revenues. No doubt the same can be said for Guernsey.

These service providers are looking to us, the States, for assurance on three things. First, tax neutral structures for their key customers, which is why we need to be able to preserve the effect of exempt companies in the way in which I have already outlined; secondly, a competitive rate of tax on their own profits, which we must always remember derive from activities that, in general, are highly mobile; and thirdly, a competitive economy generally.

For these reasons, it is important to signal now – subject to all the safeguards, and of course the ultimate decision of this Assembly – that our intention is not only to move towards new fiscal structures that address the Code of Conduct, but also to do so in a way which keeps Jersey competitive. The Policy and Resources Committee is determined that we do not sit back and allow rival

jurisdictions to steal a march on us on tax competition, because our vital economic interests would be at stake were we to do so."

9. Continuity and certainty are important features of any tax structure if business is to have confidence in making decisions for the long term, and the corporate tax regime was designed with this principle firmly in mind. In the expectation that the corporate tax regime would remain unchanged for the foreseeable future, a number of measures were adopted to deal with the resulting substantial reduction in corporate tax revenues – the introduction of goods and services tax, the removal of some personal allowances, and cuts in public expenditure. The intention of these changes was also to broaden the tax base which is considered to be an important aspect of any sustainable regime. It should also be noted that the reduction in corporate tax revenues arose mainly not through the introduction of the zero rate but through the need to reduce the tax on financial services activities from 20% to 10% to remain competitive with other jurisdictions.

What was the reaction to the zero/ten tax regime on the part of the Code Group

10. The Code Group was informed of the introduction of a zero/ten regime in Jersey as part of the agreed roll back for former harmful measures in 2002. The Code Group report of the 26 November 2002 (14812/02) FISC 299 states:

"Jersey proposes, following agreement in the EU of the Tax Package, to introduce legislation to establish a reform of business taxation to be completed within five years from the time of the agreement. Jersey intends to abolish the measures by introducing a general reform of its corporate tax system. Under the proposed new corporate tax system the standard rate will be zero for all business activities, with a special higher rate (yet to be determined) to apply to regulated entities, including financial services businesses, and to public

utilities. The standard rate will apply to approximately 21,500 of the 22,000 companies in Jersey, representing approximately 65% of the Island's income."

In the report of the ECOFIN meeting on the 3 June 2003 – 9844/03 (PRESSE 149) - it was stated that the replacement measures had been reviewed by the Code Group and were not considered to be harmful in the meaning of the Code.

What was the reaction to the zero/ten regime on the part of the UK?

11. When the zero/ten regime was proposed in 2002/2003 it was accepted by the United Kingdom. Although Jersey has fiscal autonomy, it is to be expected that the United Kingdom would have informed the Island authorities if they thought what was being done was in conflict with what were perceived to be the obligations of the Island, in the light of its voluntary commitment to the Code.

12. When the approach adopted by the Island to review its business tax measures to remove the harmful elements was considered by the Code Group in 2002, and to which the ECOFIN report of June 2003 referred, there was not before the Code Group or ECOFIN information relating to the deemed distribution provisions. However, this was not the case when, in June 2007, the Secretary of State at the Department for Constitutional Affairs and Lord Chancellor, Lord Falconer, wrote to the Chief Minister, Senator Walker, and stated –

"The United Kingdom Government welcomes and supports the efforts made by Jersey to develop a taxation strategy aimed at meeting Jersey's commitments under the EU Code of Conduct for business taxation.

The proposed introduction of a zero-ten rate in Jersey is a result of a programme of modernisation of the Jersey tax system designed to be in

compliance with international standards. Jersey has kept HM Government informed of developments in relation to the reform of its tax system.

I recognise that this requires some difficult decisions, particularly in relation to the uncertainty around the Code process. However, UK Government officials will continue to work with your officials to ensure that Jersey meets its commitments under the Code."

At that time the view of the United Kingdom was that the deemed distribution provision, as an anti-avoidance measure, was personal and not business taxation and therefore did not fall within the scope of the Code. No objection was raised by the UK to the adoption of this provision.

13. In September 2009 Jersey was informed that some EU Member States thought that 0/10 could offend the spirit of the Code if not the Code criteria per se. Jersey was asked to consider working towards a new corporate tax system that would be considered by the Member States to be compliant with the spirit as well as the form of the Code.

14. In February 2010 Jersey was informed that the Chairman of the Code Group would appreciate an up-date on developments in Jersey regarding the review of business taxation that the Minister for Treasury and Resources had initiated. The Chairman of the Code Group was informed, among other things, that the Treasury and Resources Minister in his budget speech in December 2009 had restated Jersey's commitments to the tax norms of non-discrimination, had emphasised the need to ensure a level playing field for Jersey's businesses, and had stated that the business tax review underway would consider all the options.

15. Subsequently in April 2010, the Chairman of the Code Group was told that the review of business tax structure in Jersey was being

undertaken constructively and promptly. He was also told that Jersey would find it helpful to see its policy of compliance with international standards, and its good neighbour policy with the European Union, being better responded to by EU Member States. As an example, it was pointed out that it was a disappointment to Jersey that, notwithstanding its record of compliance with international standards of anti-money laundering to an extent that contrasts with the level of compliance of some EU Member States, it had still not proved possible for many EU Member States to accept Jersey as an equivalent jurisdiction for the purposes of the Third Money Laundering Directive.

16. At the end of May 2010 the Code Group reported to the ECOFIN Council and stated that "with respect to Jersey and the Isle of Man, the Group requested the Commission's services to prepare agreed descriptions of these measures, in consultation with the UK".

<u>How the zero/ten tax regime as a whole has been considered in 2010</u>

17. **The Code Group met on the 23 September 2010:** at this meeting the Code Group received from the Commission a description of the zero/ten tax regime as a whole , Jersey having confirmed that the Commission's understanding of the zero/tax regime was correct. Jersey was invited to attend the meeting, make a presentation and answer questions. This was the first time that a non-EU jurisdiction had been invited to attend a Code Group meeting.

18. In the presentation made to the Code Group the following points, among others, were made –

"When introducing 0/10, we expected it to be sustainable for the foreseeable future. Continuity and certainty are important features of any tax structure if business is to have confidence in making decisions for the long term, and our

current corporate tax regime was designed with this principle firmly in mind."

"The deemed distribution and attribution arrangements are part of the Island's personal tax anti-avoidance measures, and are a reinforcement of anti-avoidance measures that have been in place for many years. They are not part of the business tax regime and so should be considered distinct from the business tax regime – there is no obligation on a company in respect of any liabilities arising from these rules."

"Jersey is not a member of the EU and the provisions of Protocol 3 attached to the UK Treaty of Accession, which defines the relationship between the EU and Jersey, could only be applied to matters of EU tax policy through a formal process of renegotiation of the Protocol. However, Jersey has pursued a "good neighbour policy" with the EU on tax matters including the removal of harmful tax measures and the agreements entered into on the taxation of savings income. In making any change to our corporate tax regime in the future proper regard would continue to be had for the Code criteria. Stability and certainty are essential for the future economic well being of Jersey. Political support also will be needed within Jersey for any change to be implemented. Therefore, if the Code is to have any bearing on any change in our tax structure the Code Group needs to make it clear why the regime is in conflict with the Code so that any roll back or replacement measure can be properly considered. Further there will need to be a clear unequivocal acceptance by the Code Group that any proposed future change is not in conflict with the Code before we consider commencing the relevant consultative and ultimately legislative process required for any change in the present tax structure to be implemented."

19. At the meeting of the Code Group the questioning focussed on the discriminatory aspects of the deemed distribution provision (i.e. in the view of some Member States there was a difference in the treatment of resident and non-resident shareholders of a Jersey company). In summing up the meeting the Commission specifically asked the Code

Group to consider whether the deemed distribution provision was personal taxation or a way of maintaining a 20% tax rate for Jersey companies owned by Jersey residents.

20. The Commission was then asked by the Code Group to prepare an assessment of the zero/ten tax regime as a whole on the basis of the Code criteria. As noted in para 6 above this assessment rests on the assumption that the deemed distribution provision is part of the Island's business taxation regime and not personal taxation.

21. Based on the view that the deemed distribution provision is interlinked with the zero/ten regime as business taxation and therefore within the scope of the Code, the Commission then identified areas of discrimination between residents and non-resident shareholders that in their view meant that the regime failed three of the Code criteria –

Criterion 1 *– whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents.*

The 0% effective tax rate for Jersey profits was considered to be de jure only available if the Jersey company that realises the profits has non-resident shareholders.

Criterion 2 *– whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base.*

The Commission was of the opinion that the combination of the 0/10 regime and the deemed distribution and attribution provisions for resident individuals was designed to offer a 0% tax for business profits of foreign investors while ensuring proper taxation of existing domestic business profits and important domestic revenue generators (banks and real estate). Jersey in the view of the Commission had thus protected its domestic tax base against the effects of a 0% of business profits tax and had effectively ringfenced it from the domestic market.

***Criterion 3** – whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such advantages.*

The Commission's view was that the 0% effective tax rate for Jersey companies with non-resident shareholders did not require any substance.

22. The Jersey authorities informed the Code Group through the Commission that, while remaining of the view that our shareholder taxation provisions represented a personal tax and not a business tax arrangement, they recognised the concerns of Code Group members regarding the apparent different treatment of Jersey and foreign shareholders in Jersey companies. The Group was informed that Jersey was prepared to work on a scheme that met these concerns.

23. **The Code Group meeting on the 19th November:** at this meeting the Code Group accepted the view of the Commission and agreed that the measures (i.e. the 0/10 regime as a whole) gave rise to harmful effects. Because the Jersey authorities were not invited to attend the meeting on the 19 November when this decision was reached, and the Commission's evaluation of the measures was discussed, we are not aware of what was covered in the discussion or what views were exchanged. What we do know however is that, while the Group agreed that the measures gave rise to harmful effects, the Group also then recommended to ECOFIN that the Council should review this on the basis of the conclusions of the Council High Level Working Party's work on examining the scope of the Code. It is understood that the Code Group's recommendation arose from a wish on the part of some Code Group members, supported by the Commission, to have the Council High Level Working Party examine the scope of the Code, particularly in relation to what should be considered to be business taxation.

24. The UK, in reporting to Jersey on the outcome of the Code Group meeting of the 19 November, stated that -

"Following the discussion of the Commission's paper and the additional information you put in, there was a consensus that the Jersey regime is harmful. There has not though been a formal assessment as yet and there will be further process to go through before we get to a final decision."

25. **The ECOFIN meeting on the 7th December:** at this meeting the Code Group's report was noted. Following the recommendation of the Code Group the Council High Level Working Party under the Hungarian Presidency will now be asked to address the scope of the Code of Conduct and to report back to ECOFIN by the end of the Presidency in June 2011. The UK has told us that the High Level Working Group will focus on the scope of the Code generally and not the 0/10 regime per se. However, clearly the report of the High Level Working Party on the scope of the Code – particularly what comes within the definition of business taxation and what is clearly personal taxation, which are both matters of interest to the Member States – will be material to what action Jersey has to take to remove the harmful effects from the present 0/10 tax regime. For this reason it is our view that no proposals for any change in the existing zero/ten regime can or should be finalised until the report of the High Level Working Party is to hand.

26. We will be seeking to engage with the High Level Working Party through the EU Council Secretariat. When a harmful tax measure is identified in respect of a Member State (e.g. presently Hungary is in this position) the Member State has every opportunity to present its case, engage in the discussion on the tax provisions, and gain an understanding first hand of what aspects of the provision are of concern to other members of the Code Group. Jersey has not been given this opportunity to-date other than at the meeting on the 23rd

September. It has had to rely on the United Kingdom to act on its behalf before the Code Group, and it has to be recognised that the interests of the United Kingdom and those of Jersey may not be the same. This is reflected in the footnote to a document presented to the Code Group which states *"this room document contains data provided by Jersey, and the views of Jersey, not the UK. The UK is facilitating the transmission of Jersey's views to the Code Group."* When in 2002 Jersey agreed to undertake to comply with the Code of Conduct it did so on the understanding that Jersey would be fully engaged in the process, and that the process would be fully transparent and based on a reasoned analysis of which Jersey would be fully informed. In the absence of an inclusive process we have had to rely on several sources for an understanding of what was discussed at the Code Group meeting on the 19th November and the ECOFIN meeting on the 7th December.

27. As soon as the report of the High Level Working Party is made available to the Jersey authorities States Members will be informed of the conclusions reached, and what the possible impact of the conclusions might be for the 0/10 tax regime. In the light of the High Level Working Party's report we expect to be in a better position to consider a revised corporate tax regime which rolls back what is considered to be the harmful effects of the present regime and meet the concerns of the Code Group. This revised proposal, it is presumed, would need to be evaluated by the Commission on behalf of the Code Group against the Code criteria, and on the basis of what the High Level Working Party will have said about the scope of the Code.

28. The Jersey authorities will expect to be invited to be a party to the Code Group's deliberations prior to any decision being made on whether a revised corporate tax regime is Code compliant, which decision it is presumed would then be included in a report by the Code Group to ECOFIN.

17 December, 2010