Report from the Minister for Treasury and Resources

Response to P157/2010, seventh amendment, relating to non-locally owned companies

Executive summary

1. This report is presented to the States in response to the Deputy of Grouville's amendment to proposition P.157/2010 which asked the Minister for Treasury and Resources to examine ways to raise additional revenues from non-Jersey owned companies paying tax at 0%, provided that any changes should not jeopardise Jersey's business tax regime or its international competitiveness.

2. Since the amendment was approved in December 2010, there have been the following significant developments:

   i. Jersey's corporate tax regime was confirmed as being compliant with the EU Code in December 2011.

   ii. The repeal of the deemed distribution rules has removed much of the (perceived) discrimination between Jersey and non-Jersey resident owners of Jersey companies.

   iii. Additional anti-avoidance rules are contained in the 2013 Budget proposals which will address the risk of abuse of the company tax regime. In addition, there are changes to the tax law that will prevent existing abuse of the law in relation to property ownership (group relief rules).

3. In summary the findings are:

   i. A tax or charge linked to profits risks compromising the compliance of our regime with the Code of Conduct on Business Taxation.

   ii. A tax or charge which is specifically aimed at one sector or selectively affects non-locally owned companies will feed through to Jersey residents through higher prices, reduced wages or increased unemployment.

   iii. A measure aimed at non-locally owned businesses will deter inward investment and so be detrimental to economic growth.

4. The Minister proposes the following course of action:

   i. Request the States support the anti-avoidance measures in the 2013 Budget.

   ii. Support the White Paper on data collection to ensure the States has up-to-date information to support the continuation of the current corporate tax regime and to develop future tax policy development.

   iii. Support the work on a substantial review of land and property taxation including some further anti-avoidance provisions relating to property ownership. Some changes may be proposed in the 2014 Budget, although their implementation may be phased in over a number of years due to the

economic situation. An update will be provided on the progress of that work in advance of the 2014 Budget.

Introduction

5. The report sets out in summary:

- The background to the proposition
- The development of the current company tax regime
- Options considered to address the proposition
- Findings of the review including the issues arising
- Conclusions from the review

6. A detailed report prepared by the Tax Policy Unit has been published alongside this report.

Background

7. It is important to note that this review has not been carried out with the intention of dealing with a specific need for additional revenues. The purpose is to deal with one of the principal objections to the introduction in 2008 of the current company tax regime, commonly known as zero/ten – that is its perceived unfairness.

8. In 2010 the Deputy of Grouville lodged an amendment to the 2011 Budget which called on the Minister for Treasury and Resources to introduce measures to increase revenues from non-Jersey owned companies paying tax at 0%. This amendment was approved by the States, as amended by the Treasury & Resources Minister to provide that any changes could only be implemented provided they did not jeopardise Jersey's business tax regime or its international competitiveness.

9. The reference to non-locally owned companies reflected concerns that the shareholder taxation rules meant that there was no level playing field between companies owned by Jersey residents and companies owned by non-residents. Originally, Jersey and non-Jersey resident shareholders in Jersey companies were treated differently through the shareholder tax (deemed distribution and attribution) rules. Jersey resident shareholders were deemed to have received, and were taxed on, a dividend even if the company made no distribution. Non Jersey resident shareholders were not subject to such a charge. This lead to the view that there was not a level playing field between Jersey and non-Jersey owned businesses.

10. This issue has been dealt with through the removal of the deemed distribution and full attribution rules from 1 January 2012.

11. However, there remains the concern by some commentators that, as a result of introducing a general rate of tax of 0%, the majority of non-locally owned companies which do business in the Island do not pay Jersey income tax on their profits.

12. Some commentators are also, mistakenly, of the view that by subjecting all non-locally owned companies to tax as was the case prior to the change to a 0% rate, substantial amounts of revenues will be raised with no adverse consequences.

13. These companies make a large contribution to States revenues through social security and rates and some pay GST. They also contribute to the economy more broadly as employers, providing employment opportunities for Islanders outside the financial services industry, paying the wages that enable their employees to live in Jersey. The income tax and social security their employees pay also fund the provision of public services. By providing the goods and services that Islanders want to buy and widening the range of businesses here they also strengthen GST revenues, and make the Island a more attractive place in which to live.

14. Work has been ongoing to identify and evaluate the different options for raising revenues from companies currently paying tax at 0%. This has been informed by the comments of the EU Code Group on our current regime. In particular, the Code Group made it clear that tax measures aimed at company shareholders may be considered to form part of the overall company tax regime.

15. Since this work was begun as part of the Business Tax Review in late 2009the economic climate, both locally and globally, has continued to deteriorate. Although the numbers in employment are close to peak levels, at the same time more people are out of work. Business confidence, particularly in retail, continues to decline. The downscaling of the fulfilment industry has added to the level of unemployment, especially amongst those without specialist skills. The youngest and most vulnerable in our community have been most affected.

16. Careful consideration has been given to how the company tax regime can best support the States' economic growth and inward investment strategies. In particular, the likely impact on employment of any new measures must be taken into account.

Development of the current tax regime

17. During the early 2000's Jersey was under pressure to change its tax regime from two main sources.

18. Firstly, the European Union's work to enforce its Code of Conduct on Business Taxation ("the Code"), intended to stop territories from using discriminatory tax rules to attract business from non-residents. This meant that the Island could not longer offer preferential tax treatment to companies owned by non-residents.

19. Secondly, the competitiveness of Jersey's tax rates was being eroded as other competitor offshore and onshore jurisdictions moved to reduce their own tax rates. The highest company tax rate in Jersey of 20% was no longer considered low in the face of this increasing competition from Ireland, Malta and other territories which were reducing their company tax rates to attract new business.

20. In addition, as an international finance centre Jersey had to be able to continue to offer a tax neutral regime for clients of the financial services entities.

21. The combination of these different pressures led the States to introduce the current system of company taxation with a general rate of tax of 0% and 10% for certain financial services companies in 2008.

Jersey's previous company tax system

22. Until 2008 Jersey's company tax system included the following features:

- Exempt company – available to any company owned by non-residents and which, broadly, did not carry on a business activity in Jersey. Exempt companies were exempted from tax on all income earned outside Jersey and interest arising from Jersey bank accounts. An annual fee of £600 was payable.

  Exempt companies were typically used by clients of the finance industry to act as tax-neutral vehicles for the holding of investments outside of Jersey. As such, they were an important part of Jersey's ability to attract private clients, funds, insurance, securitisation, trust and financing business to Jersey. The trust and fund industries together employed just over a quarter of those employed in the financial services industry in 2011, and 6.4% of all Islanders in work[1].

- International Business Company (IBC) – also only available to companies owned by non-residents. Tax was charged at 30% on Jersey-source income and at rates between 20% and 0.5% on international income. The average annual effective tax rate payable by IBCs was approximately 14%.

  Typically, IBCs were banks, group service companies and other businesses which had a presence in Jersey but whose work was "international" in nature; i.e. derived from clients based outside of the Island. The banking industry is the single largest employer in Jersey, with 5,270 employees in 2011 representing nearly 10% of total employment[2].

- All other companies were liable to income tax at 20%.

The Code of Conduct – review of Jersey's former tax regime

23. The European Union has no jurisdiction over direct taxation matters and therefore individual Member States retain the right to set their own tax rules, including their own tax rates. However, during the 1990s there was a concern that Member States were using their tax regimes to unfairly attract business away from other Member States. A set of principles was devised (the Code of Conduce on Business Taxation, "the Code") which all Member States agreed to implement. The Code applies to laws, regulations and administrative practices.

24. When determining whether a tax measure is harmful, the Code asks:

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

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[1] "Jersey Labour Market at December 2011", States of Jersey Statistics Unit, 28 March 2012.
[2] Ibid.

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

- Whether advantages are granted even without any real economic activity and substantial economic presence within the Member States offering such tax advantages.

- Whether the rules for profit determination in respect of activities within a multinational group of companies depart from internationally accepted principles, notably the rules agreed upon within the OECD.

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

25. A review in the early 2000s conducted by the Code Group found that the parts of Jersey's tax regime which allowed companies owned by non-residents to avail of low rates of tax on "international" income, or in some cases to be exempt from tax altogether, were harmful. Although Jersey is not a member of the EU, it voluntarily agreed to comply with the Code and with the findings of the Code Group. As a result, in 2003 Jersey agreed to abolish the harmful elements of its tax regime including the exempt company and IBC regimes.

International competition

26. The early 2000s saw a general reduction in company tax rates across the EU and further afield. Former Eastern Block countries like Estonia and Hungary introduced low rates in an effort to make themselves more attractive to foreign investment. Ireland dropped its company tax rate to 12.5% and Cyprus to 10%.

27. Faced with these pressures, it was clear that Jersey's top rate of company tax of 20% was no longer attractive in an increasingly competitive international environment. After much consideration and public consultation, the decision was taken that Jersey should reduce its rate of tax for financial services to 10%.

The current company tax regime

28. The current regime of a general rate of tax of 0% was designed to meet the following key objectives:

    - To ensure compliance with the Code of Conduct on Business Taxation by removing discrimination between companies based on the place of residence of their shareholders.

    - To maintain the ability of Jersey to offer a tax-neutral holding company vehicle to clients of the finance industry.

    - To ensure that Jersey could offer a competitive rate of company income tax to the Island's financial services sector, recognising that this industry is the largest employer in Jersey.

- To protect States' revenues as much as possible, recognising that the finance sector was the single largest contributor to States' revenues.

29. Under the new tax regime, the previous company tax system was abolished and replaced with a general rate of company income tax of 0%. A very limited class of companies are taxed at a higher rate of 10%: banks, trust companies, investment companies and fund administrators and custodians. Collectively these are referred to as "financial services companies" although not all companies considered to be in the financial services industry are taxed at the 10% rate, in particular fund managers and insurance companies. Utility companies are taxed at 20% on their profits, as are any profits derived from land or buildings in Jersey or from the importation of hydrocarbons.

30. Under the previous tax regime, the general rate of tax was 20% and special treatment was given to some companies allowing them to be taxed at lower rates, or to pay no tax at all. Under the new regime, the majority of companies pay at the 0% rate and a minority of companies are in effect "discriminated against", which is permissible within the letter of the Code.

31. The financial sector was chosen for the higher rate of tax on the basis that it was the single industry with the highest profits and therefore the greatest scope to generate tax contributions. Also, charging this industry some tax would not affect Jersey's competitive position provided the rate charged was not too high.

32. Although Guernsey and the Isle of Man have also adopted a similar tax regime, the scope of the 10% rate, and therefore the tax collected, is much wider in Jersey than in either of the other islands. The scope for widening the 10% band further may therefore be limited for a number of reasons including the risk to Jersey's compliance with the Code and the potentially detrimental effect on inward investment and economic growth.

The Code of Conduct – review of Jersey's current tax regime

33. A formal review of the new company tax regime was conducted by the European Union's Code of Conduct Group in 2010 and 2011. Jersey defended its position and succeeded in securing the acceptance that the company tax system in itself was not harmful according to the Code criteria. This provided much-needed stability and certainty for businesses in the Island and those thinking of investing here. This is particularly important in the current environment, with the effects of the global economic climate still being felt.

Options reviewed and work undertaken

34. The Tax Policy Unit has reviewed the main options available for raising revenues from non-financial services companies. The following methods of increasing revenues have been considered in detail:

    - Extending the scope of the 10% or 20% band. Focus has been put on the retail sector, as the most visible example of non-Jersey owned companies trading in

Jersey, and therefore the focus of most of the concerns to date but this could apply to any sector which is currently taxed at 0%.

- Introducing a charge on all companies, for example based on headcount or property occupied. The effect of any non-profit based charge has broadly the same economic effect.

- Restricting input GST recovery for all companies.

35. External economic advice has been sought from Oxera.

Key objectives of the review

36. Each method has been reviewed in light of the key objectives, namely:

Supporting the inward investment/economic growth strategy

37. While Jersey continues to experience the effects of the global downturn, and with unemployment rising by the month, in particular in the non-finance sector, any changes to the tax regime must promote conditions for economic growth by encouraging existing businesses to grow and attracting new business to Jersey.

38. Given the difficulties posed by the current economic climate and the high level of unemployment it is important to limit economic distortions as far as possible and understand the economic impact locally of any changes.

39. Stability of and certainty in the tax regime is important in building and maintaining business confidence.

Protection of the current company tax regime

40. The Business Tax Review found that the general rate of tax of 0% and a 10% rate for financial services is still overwhelmingly favoured by the majority of Island businesses. Any changes to the tax system must therefore protect the current regime.

41. Key to this is the ability to demonstrate that the general company tax rate in Jersey is 0%, i.e. this is the rate of tax paid by the majority of companies in Jersey, on the majority of profits earned in Jersey, by the majority of employers in Jersey and by the majority of businesses actively carried on in Jersey. This last point has recently emerged, based on the European Commission's review of 0/10 as part of the recent Code Group review. This will significantly limit Jersey's ability to extend the scope of the 10% band, or any other tax-like charge, while maintaining its Code compliance.

Any changes must be sustainable in the medium term

42. Stability of and certainty in the tax system is important in building business confidence and hence supporting growth. Jersey has been through significant changes in its tax regime in recent years and a period of stability would be beneficial.

43. Undertaking a fundamental change in the tax regime so shortly after introducing the new regime would be destabilising and create uncertainty. Even making small changes could adversely affect confidence.

44. Any changes made must be sustainable in the medium to long term. Therefore it is important that any changes are compliant with international standards to avoid the risk of challenge.

Findings from the review

45. The abolition of the deemed distribution and full attribution rules at the end of 2011 has removed much of the perceived "unfairness" of 0/10, in that neither Jersey resident nor non-resident shareholders of Jersey companies are taxed unless and until profits are distributed.

46. Companies, whether Jersey or non-locally owned, paying tax at 0% make a large contribution to Jersey, beyond tax revenues. They employ 65% of all individuals employed in the Island and pay social security on their staff costs and some companies pay GST. The wages they pay their staff are subject to income tax, and a large part of those wages is spent on-Island, generating further revenue and economic activity.

47. The tax system must support the States Strategic Priorities and Economic Growth Strategy. Key to both of these policies is the support of economic growth and the protection and creation of employment for Islanders.

48. It is necessary to weigh the competing desires to protect Jersey's economy with the desire to increase revenues from non-locally owned companies.

49. Many non-financial services sectors have suffered a decline in profitability. As a result, the potential revenue increase from introducing a tax on profits will not be significant.

50. There are two key factors to consider in respect of any measure taken. Firstly, it is important to protect the current tax regime which is critical to support the finance industry and to maximise the opportunity for inward investment.

51. Introducing a profits tax to all non-locally owned businesses will result in the current regime being considered harmful by the Code Group as it would be impossible to defend the position that zero is the general rate of tax, particularly in light of the EU Commission's comments in their review of Jersey's tax regime in 2010/11.

52. Introducing a charge which is linked to profitability would fall foul of the Code as it will likely be considered a tax rather than a charge and hence challenge the concept that 0% is the general rate of tax.

53. Even if the charge is not directly linked to profitability, there is a risk that the Code Group would consider it to be so closely related to the on-island business activity and hence fall within the scope. In that case, as with extending the 10% band, it is likely that they would challenge the general rate of tax being 0% resulting in the regime being non-compliant.

54. There is insufficient data available to allow a robust understanding of the nature of Jersey's potential taxpayer base both in terms of sector and profitability. This lack of

data makes it is difficult to say with any certainty whether any changes would ensure that the general rate of 0% can be protected. It also makes it difficult to estimate the potential revenue any such measure might raise.

55. The second key factor is whether any change can be made without adversely affecting the economy through increased prices, reduced wages and jobs or loss of economic activity through business migration or deterring inward investment.

56. Oxera advises that of all the options for increasing revenues from non-financial services companies, extending the scope of the 10% or 20% tax band very slightly is likely to be least economically damaging, compared with the other options.

57. However, they also advise that if the States seeks to raise additional revenues from a specifically targeted sector of the business community, that additional revenue will be paid for by Jersey residents. This would be through a combination of increased prices (inflation), reduced wages or employment. Jersey residents could also suffer from loss of choice in the market as businesses close down. Imports would also become cheaper that locally produced items, due to the increased cost which would have a detrimental effect on on-island businesses.

58. Specifically in relation to tax, the effect of increasing the tax cost to increased prices is likely to be greater if targeted at non-locally owned businesses or at sectors which are dominated by non-locally owned companies.

59. Extending the scope of the 10% or 20% bands of tax to specified sectors would put Jersey at a competitive disadvantage to Guernsey and the Isle of Man and so potentially restrict Jersey's ability to attract more high value low footprint activity. While the current difference between the islands tax regimes has not had a significant affect on Jersey's ability to succeed in the financial services sector, the same may not apply to other sectors. This too may be counter to the inward investment/economic growth strategy.

60. In recent years, as tax rates have generally fallen, focus has moved away from taxing income in favour of taxing consumption. In that environment, renewed consideration has been given to the options for raising revenues through the taxation of land and property.

61. If additional revenues are needed in future and if this could only be achieved through an additional charge on business, a charge based on property would be the least damaging economically. It should not however be considered to be the 'holy grail' as there are some downsides to property tax, despite it being a relatively efficient tax. This will need very careful review and consideration.

62. Jersey taxes property lightly, particularly in relation to commercial rates. Jersey should consider ways in which its property tax regime may be reformed with a view to raising additional revenues.

63. It is evident from the work undertaken during this review that there is scope to tighten the rules on interest relief relating to property ownership, so that landlords of property in Jersey cannot claim excessive relief thereby avoiding a tax liability. This is particularly relevant to non-resident landlords.

Conclusions

64. The advice received from the Tax Policy Unit, supported by external economic advice, is that introducing a tax or charge for companies paying tax at 0% would damage the already fragile economy and potentially result in another costly EU Code of Conduct Group review of our tax regime, leading to further uncertainty.

65. While the least economically damaging option is to tax profits, through extending the 10% or 20% bands, it is not certain that in doing so Jersey's corporate tax regime, and in particular tax neutrality, can be protected from challenge by the EU Code of Conduct Group. This is the case even if the change is restricted to non-locally owned companies.

66. A significant factor in this is the lack of current data on company profitability for those companies subject to tax at 0%.

67. Unless that data is available, making changes to the company tax regime may not be sustainable. For these reasons, a White Paper has been issued with a proposal to ensure this necessary information is routinely collected in the future.

68. A charge of whatever form will likely feed through to prices, wages, jobs and potentially business activity. In the current climate, this would be particularly damaging to economic growth.

69. Given these constraints, consideration should be given to ensuring that the taxes due under the current regime are collected.

70. Work is being carried out to review the tax legislation in relation to interest relief with a view to ensuring a full return on Jersey property is achieved, particularly from non-resident landlords.

71. In the future, should the economic climate improve sufficiently, consideration may be given to extending the property tax regime. Property in Jersey is taxed lightly, in particular through commercial rates. A review will be undertaken to review the scope to change the way property is taxed more generally. A commitment has already been given to undertake a review of this type and that review is underway.

Senator P.F.C. Ozouf
Minister for Treasury and Resources
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