



Report to

The States of Jersey

**Shadow Scrutiny Committee
on the General Sales Tax**

Jersey's tax reforms

and the

**EU Code of Conduct on
Business Taxation**

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Executive Summary

Jersey is introducing new taxes. It is not doing so by choice. It is doing so because the European Union (EU) has required it to do so to comply with its Code of Conduct on Business Taxation (the Code). The main new taxes are:

1. a 0% tax on the profits of most corporations;
2. a 10% income tax on the profits of financial services companies;
3. a new income tax charge on the part of the taxable profit of a company a Jersey resident person is deemed to have entitlement to as a result of owning shares in a company, whether it is resident on Jersey or not;
4. a General Sales Tax (GST), which is a VAT in all but name.

As Jersey is changing its tax laws to meet the requirements of the EU it would seem that its primary objective in designing any new tax system would be to ensure that they met the requirements of the letter and spirit of the EU Code of Conduct on Business Taxation, and other EU requirements to which Jersey now appears subject. Key elements of that Code are attached to this report as Appendix I. Other parts are referred to, and are reproduced, in the report.

As this report shows, the new laws that Jersey is proposing to introduce do not appear to meet the requirements of that Code. This is because:

1. The new 0% corporation tax rate on Jersey companies will not in fact be any such thing, unless the company is owned by persons not resident in Jersey. If the company has any shareholders (excluding, apparently, charitable trustees) resident in Jersey then it is planned that the company be legally obliged to pay a sum equivalent to tax at 20% on its profits to its shareholders so that they may pay tax on those profits as if they were their own, whether or not all those profits have been paid to them. This proposal is contrary to the requirements of the Code because:
 - a. it will create an obligation on a resident owned company to pay a sum equivalent to tax that will not exist on non resident companies;
 - b. that obligation will be calculated as if it were tax;
 - c. the deeming of this liability to be that of the shareholder rather than the company does not alter the fact that this is a tax which will be charged on the profits of resident owned companies which will not be charged on non resident owned companies;
 - d. the creation of any obligation (as is inevitable) to report the payment made to the taxation authorities including the provision of details of

to whom it has been paid to enable those authorities to ensure that the sum paid as a dividend can be collected as tax from the recipients (as will surely be required) only proves that this is a tax in all but name, and therefore must be recognised as one;

- e. this law does apply to companies and does relate to tax and does result in companies owned by Jersey resident people having a competitive disadvantage when compared to companies that are owned by non resident people since the latter can accumulate all their profits at will if they so wish but companies owned by Jersey resident people cannot;
- f. it can only be presumed that this tortuous and complex process has been introduced to provide advantages to non resident companies that are ring fenced from the domestic market so they do not affect the national tax base.

As such this proposal reproduces the ring fence that exists under existing Jersey tax law which has largely ensured that only companies owned by Jersey residents have been taxed whilst companies owned by those who were not resident have, in the main, not been taxed. It does so to protect domestic tax revenues. As such this provision contravenes section B2 of the Code.

In addition, the inclusion of de minimis rules to allow the partial operation of this rule allows tax to be paid, or not, depending upon arbitrary rules which have inherent within them the possibility of the law being flouted in contravention of section B5 of the Code;

2. The proposed new 10% tax on the profits of financial services companies is in contravention of sections B1, B2, B3 and B5 of the Code. Under this proposal it is suggested that only companies in the financial services sector regulated by the Jersey Financial Services Commission will be subject to this charge to tax. But regulation by the JFSC is not required of companies undertaking transactions in the financial services sector in Jersey if they are undertaken through Special Purpose Vehicles (SPVs) as defined by the Financial Services (Jersey) Law 1998. For the purposes of that Act SPVs are very widely defined, and may be any company that the JFSC decides as being an SPV, in effect at its discretion. To date SPVs have been deemed, as far as it is possible to determine, to be companies operating in the financial services sector in the main but which:
 - a. are not owned by Jersey residents;
 - b. supply services within Jersey but for the benefit of persons not resident in Jersey;
 - c. undertake a very limited range of transactions for which they are specifically incorporated, each of which may have little or no economic substance within Jersey despite taking place there;
 - d. are deemed not to be resident in Jersey despite meeting all the normal tests for being so including being incorporated there, holding

all their director's meetings there and undertaking all their commercial transactions there.

Individually and in combination these factors ensure that the new law will fail tests B1, B2 and B3 of the Code. The discretion granted to the JFSC to deem any activity one undertaken by an SPV ensures that the proposal will also fail test B5 of the Code.

3. The proposed GST includes a provision that the financial services sector will be subject to special arrangements to tax that will determine the extent, if any, to which it is taxable dependent upon each individual participants customers, or customer mix. It would appear that this option is being chosen because this will impose a smaller charge upon the sector than would be the case by exempting it from the tax altogether. The arrangement does not, however, meet the requirements of the EU Code for a number of reasons:
 - a. Whilst special schemes for particular industries do exist under EU approved GSTs (for example, the UK's retail schemes for its VAT) and it is accepted that these can be individually negotiated to suit a particular company's needs in exceptional cases, such arrangements are always designed to reflect the mix of tax rates on the products supplied determined on the assumption that the supply is made within the state. There is no provision to determine the liability mix on the basis of international supplies, the claim for relief for which has to be made individually and be proved in each case. It therefore appears that any scheme based on this arrangement could be in contravention of the following clauses of the code:
 - i. clause B5 of the Code for offering too wide a discretion at administrative level and opportunity for abuse;
 - ii. clause B1 of the Code for reasons of offering a tax advantage to non residents transacting with non residents;
 - iii. clause B2 of the Code by creating a ring fence around domestic transactions.
 - b. Whilst a blanket exemption from being chargeable to the VAT of an EU state in which a person or company is resident can be obtained under EU VAT rules if it can be shown that supplies only occur outside that territory this is only possible if the consequence is to deny input tax that the registered person might have reclaimed in the territory of registration in respect of supplies made entirely elsewhere. But the Jersey scheme is not of this nature. It is intended that exemption from the tax should be given on the basis of an "end user relief". But the end user in this case will not be outside Jersey. As the analysis in this paper shows, Jersey Finance, the Crown Agents and the States of Jersey all know that the SPVs created by the financial services industry in Jersey do trade in Jersey. And in the vast majority of cases they do not trade anywhere else. In other words, to offer an end user relief certificate in this case would be to simply say that part

of the financial services sector in Jersey was exempt from the GST purely on the grounds that its owners are not resident in the Island. This is the creation of a ring fence on the basis of residence of ownership and as such is clearly contrary to the provisions of section B2 of the Code. It may also contravene section B1 of the Code.

The preceding paragraph remains valid despite there being a concept of end user relief in EU VAT law. That concept is only used to grant relief from charging tax in highly specific circumstances and almost always relates to supplies to charities e.g. on the supply of lifeboats to the Royal National Lifeboat Institution in the UK.

It should be noted that these problems with GST on the financial services industry would be entirely avoided if the industry as a whole was exempt from GST in Jersey, an option that has been rejected by the States and the industry itself.

4. The proposed "look through" provisions that will charge Jersey residents to tax on an apportioned part of the taxable profits of companies incorporated outside the island and from which they have no right to demand either a dividend, or the apportionment of profits or information to determine their taxable income, would appear to be a contravention of EU regulation on human rights because it taxes a person on income they have not received and which they cannot determine.

For these reasons it would appear that whilst Jersey has complied with the requirement to remove certain of its current unacceptable tax practices (specified in Appendix 2) in the future, it is doing so only by introducing new tax measures which contravene the EU Code just as much as do some of the practices that are being abolished. In doing so it would seem that Jersey has misunderstood the Code. That Code may have listed practices that it found unacceptable at the time of its introduction, but it was not just a Code to target specific unacceptable provisions, but also set out principles which it expected its member states to comply with in the future. Each member state was to ensure that it did not introduce new taxes that breached the Code. The UK appears to have the responsibility to ensure that Jersey does not do so. Jersey appears to be failing to meet this requirement.

Furthermore, it seems that any member state of the EU may ask the UK to investigate any new tax law that Jersey introduces and to supply it with information concerning them so that it might determine whether they comply with the Code. The States should anticipate such requests. In this context the fact that Jersey has not asked the UK or the EU whether its new proposed tax laws comply with the Code exposes the Island to very considerable risk.

In practice Jersey could avoid the problems referred to in this report. It could:

- I. exempt the financial services industry from the GST. In that case the GST is likely to comply with the Code;

2. only charge the banking sector to the 10% tax rate, the other sectors regulated by the Jersey Financial Services Commission sharing too much in common with activities undertaken by SPVs to extend the tax base to them;
3. abandon the “look through” provisions.

This report suggests these changes would have a tax cost of about £52 million per annum.

This sum could be recovered by:

1. introducing new registration fees for all limited companies equivalent to the combined tax and registration fees paid by exempt companies in the past. This should collect £21 million per annum;
2. charge a registration fee for all trusts established in Jersey. This should raise at least £10 million per annum;
3. encourage distribution of dividends by Jersey companies. This should raise at least £7 million per annum;
4. exempting the financial services industry from GST which should raise at least £5 million per annum;
5. using Jersey’s share of taxation revenues arising because of the introduction of the EU Savings Tax Directive to make up the difference. This report estimates that this might be as much as £27 million per annum.

In combination these, or other taxation options proposed elsewhere, could bring the tax loss back into the required range and leave Jersey with a taxation system which complies with the requirements of the EU Code of Conduct for Business Taxation.

Since Jersey has accepted it is subject to that Code it is the duty of the States to create laws that do so for the benefit of:

- its citizens;
- the businesses that trade in the Island; and
- the finance industry that uses it as a base.

Unless it does so it exposes all those parties to significant risk, and most especially the risk that far from creating a tax system that will last for generations to come, as the States claim the new laws will do, they will in fact fail at the first hurdle of approval by those who have to be satisfied of their international legality.

Chapter I – Background to the changes in Jersey’s tax laws

Jersey is having to change its taxation rules. There are two principle reasons:

1. The OECD has launched a head long attack on tax havens meaning that Jersey has been forced, somewhat reluctantly, to agree that it will have to share more information with other taxation authorities in the future. It signed up for this in the aftermath of 9/11 when the political pressure on it to do so from the UK was too great to resist.
2. The EU, backed in Jersey’s case by the UK, launched two tax initiatives which had direct effect upon Jersey even though it was not a member:
 - The first of these was the Code of Conduct on Business Taxation launched in 1997 and published in detail in 1999. The Code is attached as Appendix 1. The specific unacceptable practices in Jersey identified in 1999 are listed in Appendix 2.
 - The EU Savings Directive tackled a personal tax abuse which is not the concern of this paper in consequence.

To meet the requirements of the EU Code Jersey has had to eliminate the situation where companies owned by non resident people could pay tax at lower rates than those paid by companies owned by Jersey residents. This has been called the “removal of the ring fence”. In effect this abolished the most popular “Special Purpose Vehicles” (SPVs) used by the finance industry, many of which have been based on the Jersey exempt company. An explanation of how the exempt company has worked is offered in this report.

In practice this has had two consequences:

1. Jersey has had to appear to offer one income tax rate to all companies (bar some in the finance sector), whoever owns them. Since a company with a 0% tax rate is seen as key to its tax haven operations it felt it had no option but do this. Some companies in the finance sector may have to pay tax at 10% in the future;
2. As this measure has meant that Jersey might lose, in its own estimate, up to £100 million of its taxation revenues out of a total current budget of approximately £470 million it has had to consider alternative, new taxes to replace that lost revenue.

This has had several further consequences:

1. political questions have arisen over the use of the Island as a tax haven and the cost / benefit of that in the new circumstances;

2. the existence of that political pressure has meant that the new taxes have been subject to wide-scale consultation and public scrutiny. That has resulted in more information being available on these taxes than has been commonplace in Jersey's past;
3. Jersey has lost some of its independence on this issue. Although no explanation has ever been offered for Jersey's cooperation with the UK and the EU, that cooperation has been offered. As a result the laws that are created need not only suit Jersey's need, they must also meet those of the UK and EU.

The consultation process has focussed on the following issues:

1. replacing the old income tax system that applied to Jersey companies with a new arrangement that means that technically no Jersey companies bar those in the finance industry will pay income tax, and with those in that industry now being required to pay 10% tax rather than the 20% they have paid for the last 60 years;
2. a proposal that Jersey people who own shares in companies, whether based in Jersey or not, pay tax on the profits of those companies and not the actual income paid to them by way of dividend from those companies. In effect this means that:
 - a. if the companies in question are Jersey resident they will be required to pay exactly the same tax after the changes as they were before the changes, but with the tax now being settled by their shareholders rather than the companies themselves.
 - b. if the Jersey company is not owned by Jersey people it will pay no tax in Jersey after the changes, which was not always the case beforehand since some companies resident in Jersey but owned by non residents did pay tax under the old scheme. The finance industry is an exception to this change, subject to the important points noted in this report.
3. a change to the tax allowances for better off people in Jersey so they pay more than 10% tax on average on their income, as has been the usual case to date and might pay something nearer the 20% tax rate that Jersey officially applies to the income of such people. Since this change is to personal tax it is outside the scope of this report;
4. the introduction of a VAT in Jersey, which for its own reasons it is calling a General Sales Tax or GST.
5. the perceived need to ensure that the SPVs created by the finance industry in Jersey on behalf of its clients do not pay tax in Jersey.

The last of these objectives is, in fact, the key objective around which all the others have been designed because this is seen as the core feature of the Jersey taxation system that provides it with its essential character as a tax haven and offshore financial centre. One consequence of this has been that a lot more has been admitted about how these SPVs work than has been recorded in public documents in the past. This has been invaluable in assessing how it is believed that the new tax system, approved in outline by The States in May 2005, might work when introduced from 2008 onwards.

Chapter 2 - The existing system – how the tax haven has worked

Some understanding of Jersey law and the operation of offshore operations is essential if a meaningful review of the new laws is to be undertaken. Dealing with offshore first, in the case of Jersey the finance industry in the Island is driven almost entirely by tax. Put simply, there is almost no reason for any financial transaction to ever take place in Jersey but for the fact that someone might obtain a tax advantage as a result. Jersey has no other attractions for finance. It has no great home grown expertise in finance that lured business to its shores. It has no significant market making opportunities of its own. There is almost no industry as such which its residents have to offer on which can pay a return to all the money that is located in the Island. That money is there for tax reasons, and nothing else.

Perhaps the first thing to appreciate therefore is that, despite the claims made by the Jersey Financial Services Commission and others, most of the money supposedly invested in Jersey is not in the Island. That is not surprising. In December 2004 the Jersey Financial Services Commission said there was £158 billion on deposit in Jersey's banks. That's approximately £1,775,000 for each person resident in Jersey, children included. Clearly that money is not being lent into the local market. Housing in Jersey might be very expensive, but it is not that expensive. To make a return on that money it has to be lent elsewhere, so the cash is not in Jersey at all. It comes in from London or other financial centres, is booked as being in a bank account in Jersey and is promptly lent by the banks who supposedly holds the money in Jersey back to the London money markets (or wherever). An understanding of this is vital. In effect what this shows is that they are just a giant accounting exercise.

The next thing to understand is that some people want to be a little more aggressive in their tax planning than to just lodge their cash in a bank account in Jersey. That might be called tax avoidance (and sometimes it might also be called tax evasion) but in between the two there is aggressive tax avoidance. That is when someone seeks to minimise a tax bill whilst attempting to comply with the letter of the law in at least one of the territories involved in a transaction whilst avoiding its purpose or spirit. This often entails setting up artificial transactions or entities to re-characterise the nature, recipient or timing of whatever is going on. When that happens through another country, it is international avoidance. Special, complex schemes are often created purely for this purpose. The SPVs that Jersey is well known for are often used as part of this process. In fact, that is often perceived to be their main purpose by many commentators and taxation authorities.

The dividing line between avoidance and evasion in these cases can on occasion be unclear because the understanding of this issue varies between differing jurisdictions. In that case it has to be said that whilst the use of these SPVs is legal under Jersey law, there can be conflicts between legality in Jersey and that in other jurisdictions and when serving an international market an understanding of this ambiguity is essential. The use of these ambiguities in territories outside Jersey is sometimes called tax arbitrage, which is commonly seen as aggressive tax avoidance and it has, for example, been the subject of some recent attention from the UK's HM Revenue

and Customs. Issues of compliance with the law do not arise as a result in Jersey, but can elsewhere, and it is for this reason that the EU, the OECD and others described the use of SPVs in Jersey created using exempt companies using terms such as “harmful”, which suggests they share the view that use of such mechanisms is aggressive tax avoidance.

To understand this “re-characterisation” consider the following description of the uses to which a Jersey SPV might be put prepared by a firm of Jersey lawyers:

“Examples include:

- *issuing debt securities,*
- *repackaging securities,*
- *asset backed securitisation,*
- *synthetic securitisation,*
- *catastrophe bonds and insurance linked securitisation,*
- *conduits,*
- *purchasing vehicles,*
- *receivables trusts in connection with securitisation structures,*
- *investments made “off balance sheet”,*
- *tax driven structured financings,*
- *debt defeasance structures,*
- *credit default and total return swap structures,*
- *Islamic financing arrangements and*
- *restructuring of security arrangements ancillary to bank financing”.*¹

Two things stand out. The first is the obscurity of what is being talked about (even if you are trained in finance). Second is the obvious fact that although the language is obscure it has its own story to tell. Conduits are passages through which things pass. That is much like money coming into and going out of banks with nothing really happening in between. And however dressed up, something synthetic is not real. Repackaging is clearly a process applied to something that already exists in the hope of giving it a new veneer, and so on. This language seems to seek to make things appear what they are not, whilst always acknowledging that the reality is not far away. And there is a widespread perception that this is what tax havens do, for they offer secret spaces in which the nature of something located elsewhere can be made to look like something it isn't, at least for a while.

This industry has been driven by a desire that people should not know what is going on, firstly to save tax, and secondly so that its consequences might be hidden. The secrecy of offshore, which still persists in much of what Jersey does e.g. because its companies are not required to file their accounts on public record and there is no charity commission, assists this process. Perhaps the “off balance sheet” financing referred to is the best example of this. The whole purpose of setting up such a structure is to make it look like a company owes less money than it does, and therefore make its finances (or balance sheet) look better than they are. This is legal, although seriously frowned upon by many regulators for fear that it might result in financial positions being misstated.

There are several things that this level of complexity requires. They are:

1. lawyers;
2. banks;
3. accountants;
4. management;
5. an infrastructure in which all these can meet.

Tax havens, and especially those like Jersey that wish to call themselves offshore financial centres, can provide these services.

There is of course one other essential ingredient. It is essential because, as with offshore banking, however attractive some of those very oddly named SPV transactions might be in their own right, none have any real worth at all unless they are undertaken tax free. The reason is obvious. Much of what takes place in tax havens is “secondary” and frequently almost hidden finance. As is clear from some of the products described above, the rates of return they offer might not be the best in the market. And there are costs of structuring deals in this way which have to be paid and which reduce the rate of return on these arrangements. But, if something is going to pay a sub premium rate of return it may be still be attractive in the financial markets if it is not taxed. So, tax is the essential ingredient in all these operations, whatever else might be said. Otherwise they could all be done more simply and cheaply in the UK, for example.

That means it is important to understand how Jersey has taxed these SPVs. Or rather, it is important to understand how Jersey has not taxed these SPVs, because that has been the reality of the situation. It has achieved this in the following way:

1. the only tax that could apply to these entities at the moment is income tax;
2. most of these entities are corporations, although some are trusts. The majority case will be considered here, trusts following broadly similar lines;
3. Section 123 (1) of the Income Tax (Jersey) Law 1961 says:

Bodies corporate

(1) Except as provided in Article 123A of this Law, a company incorporated under the “Loi (1861) sur les Sociétés à Responsabilité Limitée” shall be regarded as resident in the Island, and a company incorporated outside the Island shall be regarded as resident in the Island if its business is managed and controlled in the Island.

In other words, all corporate bodies registered in Jersey are taxable in Jersey unless offered an exclusion. In addition, Jersey management or control of a body registered elsewhere makes it Jersey resident.

4. The key parts of Section 123 A of the same Act says:

(1) A company shall, on an application in that behalf made in such manner, within such time and accompanied by such information as the Comptroller may require and on payment of the sum of [six hundred pounds], be treated for all the purposes of this Law for any year of assessment as not resident in the Island (and referred to in this Article as an “exempt company”) if –

(a) the company is a collective investment fund; or

(b) no person resident in the Island has, at any time during the year of assessment, any beneficial interest in the company other than as a shareholder in or debenture holder of a body corporate which –

(i) has a beneficial interest in such a company, and

(ii) is listed on a recognized Stock Exchange,

and disclosure has been made of either the full name and address of the ultimate beneficial owners of the shares of the company or, where the shares of the company are held on trust, the full name of the trustees, etc.

(2) An exempt company shall be exempt from income tax chargeable under Case I of Schedule D in respect of profits of a trade unless that trade is carried on through an established place of business in the Island.

(9) For the purposes of clause (iii) of sub-paragraph (a) of [paragraph (1) of] Article 61 of this Law the office of director of an exempt company shall be deemed not to be an office exercised within the Island.

(10) In this Article –

“beneficial interest” means any interest (whether equitable, legal or contractual) other than an interest as a bare nominee or trustee etc;

“established place of business” of a company includes a branch of the business, a factory, shop, workshop, quarry or a building site, and a place of management of the business, but the fact that the directors of a company regularly meet in the Island shall not of itself make their meeting-place an established place of business.

The “make believe” world of Jersey immediately becomes apparent. In section 123 (1) a company is resident in Jersey if “its business is managed and controlled in the Island” but in section 123 (A) (9) “the office of director of an exempt company shall be deemed not to be an office exercised within the Island”. It is, of course, the case that the directors of a company manage and control it. That is their job. As such if the directors are in Jersey or meet in Jersey all common sense says that directors working in Jersey make a company resident there. This is the common standard of tax law in places that are not tax havens. But section 123 (A) (9) says otherwise in the case of Jersey.

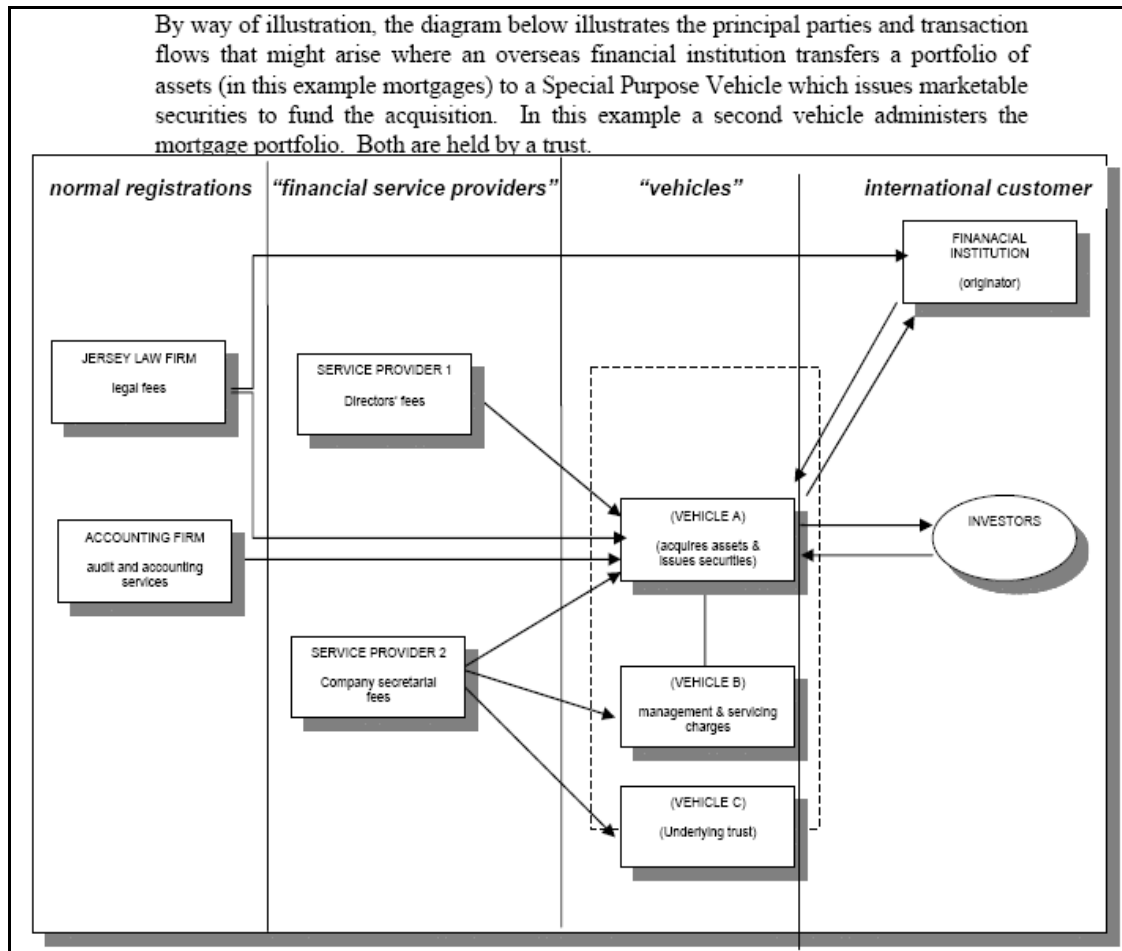
Section 123 (A) (2) does add a perspective to this. The exempt company is taxable in Jersey if it carries on trade there “*through an established place of business in the Island*”. But again, just when some normality appears in the law, Section 123 (A) (10) removes it. The SPVs we are talking about won’t have anything like a “*branch of the business, a factory, shop, workshop, quarry or a building site*”. They do very little after all. Indeed, as lawyers Bedell Cristin have noted in a published briefing:

“the memorandum of association of the SPV will often expressly limit the authority of the directors to the specific purposes for which the SPV has been established”.

That purpose might be just one transaction. So that leaves open the question of whether such SPVs have “*a place of management of the business*” and if they do, where it is. Section 123 (A) (10) says such a place is not established by “*the fact that the directors of a company regularly meet in the Island*”. But, if all the company can do is the one task it is set up for, and that happens in Jersey, whether or not the directors meet there or not seems to make no odds. If that task has happened in Jersey then someone did it, and if it was not the directors, whoever did do it must have done so through a place of business established for that purpose, even if ever so briefly. The “permanence” of the establishment might, in one sense be short over a normal perspective of time scale but when viewed in the context of the company itself, one ten minute meeting of its board of directors might be all it was established to do, and in that sense where it happened defines the location of its permanent establishment very firmly indeed. And yet, this appears not to be the case on the basis of Jersey law in the case of an exempt company. For these companies the clear fact that they are resident in Jersey by normal international taxation criteria is stated not to be the case as clearly as if a law had been passed saying black is white. It is with that much credibility that the “ring fence” around exempt companies was created. It is not surprising that the OECD and EU described such law as “harmful tax practices”.

5. This paper does not consider International Business Corporations as these are not usually used for the purpose of being SPVs.
6. A model of how an SPV works is provided by the Crown Agents in their final report on the proposed new General Sales Tax in Jersey (next page)². This involves the refinancing of mortgages (almost certainly UK mortgages) which is a quite common use for a Jersey SPV. The SPV is:
 - a. Vehicle A and is probably an exempt company;
 - b. Vehicle B is also almost certainly an exempt company and supplies management services to Vehicle A;
 - c. Vehicle C is a Jersey charitable trust.

In their report the Crown Agents make clear that they think all these vehicles operate in Jersey. That is because they think all might be subject to a possible charge to the Jersey GST they were discussing unless subject to special exemptions (a matter considered further below) deeming them not to be resident in the Island.



The use of the charitable trust is notable, but commonplace. Again, Bedell Cristin can help out here. They say:

“The SPV will qualify to apply for exempt company status in Jersey if no resident of the island has any beneficial interest in the SPV. This position will not be prejudiced if the shares in the SPV are held by Jersey resident trustees provided that the beneficiaries concerned are local charitable entities, duly exempted from local tax by the Comptroller of Income Tax in Jersey, or non residents of Jersey whether charitable or otherwise.”

This is interesting because it follows the comment that:

“exempt company status is available to Jersey and non Jersey companies managed from Jersey alike”.

Bedell Cristin are a well respected firm of Jersey lawyers. What they say is undoubtedly correct in Jersey law. It is notable that they think that management is not an issue of concern with regard to exempt companies. In fact, a company can, they clearly say, be managed from Jersey and be exempt. This initially appears contrary to section 123 (A) (2) of the law referred to above and relies as such either upon the law saying directors meetings do not, in effect, take place in Jersey when in fact they do, or the use of charitable structures created with less than obvious charitable intent, the motive clearly being commercial because it appears to assist avoidance of the payment of tax on what are, after all, commercial transactions undertaken without charitable intent. It is stressed though that what Bedell Cristin say is entirely consistent with current Jersey practice and their understanding appears widespread.

What is clear as a result is that practice has over time created an environment in which it has become increasingly easy and acceptable for a company that appears non resident in Jersey law but which would, using normal OECD criteria of residence appear to be resident there, to be both managed in Jersey and to appear to trade there without tax consequence arising. It is these dichotomies that are being used as part of the tax arbitrage process in the operation of Jersey SPVs and which are unpopular with tax authorities elsewhere.

These outcomes appear to be possible at least in part because charitable trusts are widely used in these structures to:

1. give the appearance that the SPV controlling the new operation cannot be the commercial company that set it up (the financial institution in the top right hand corner of this diagram) and
2. to ensure that the SPV is not taxed in Jersey.

There is, incidentally, no record of the sum by which local charities benefit as a result. As such this activity appears to be a potential abuse of the concept of charities, especially in a state where there is no Charity Commission and no published data on their activities.

The real question, however, is if this model is right, and everything happens in Jersey, as is implied, where does the trade take place for legal purposes? This is important. If the trade is not tax free because a charitable structure is used it is tax free because it is exempt because it is owned by non residents. In the latter case (at least) though any profits from a trade in Jersey should be taxed there, but they appear not to be and as such the trade must be considered non resident as such. The obvious follow on question to that is if the trade is not taking place in Jersey, as at least appears possible, where is it happening? Or is it just assumed (or “deemed”, as appears to be the favourite word in Jersey) to be taking place nowhere?

With regard to the first question, there are four possible answers:

1. the trade does in fact happen in Jersey;
2. the trade happens in Jersey but it is deemed not to happen in Jersey;
3. the trade does not happen in Jersey and the place where it happens knows about it;
4. the trade happens does not happen in Jersey and the place where it happens does not know about it.

There are no other options. It is not possible for a trade to take place nowhere. These options split like this:

	Happens in Jersey	Does not happen in Jersey
Tax authorities know about it	Option 1	Option 3
Tax authorities do not know about it	Option 2	Option 4

Given that it would be wise to assume the parties to a deal such as refinancing mortgages would like their deal to be legitimate then we should assume that they will want to tell the tax authorities about them. But, if they follow the apparent logic that they want what is called “tax neutrality” in Jersey, i.e. they want to pay no tax, then they would have to apply to be an exempt company. In that case they have no means of telling the Jersey tax authorities what they are doing there, even though what they are doing would appear to happen in Jersey. That is because an exempt company does not have to submit a tax return in Jersey because it is a necessary part of defining the company to be exempt that it does not have a trade there.

That must mean it is presumed that the trade does not happen in Jersey. Now either something happens in Jersey or it happens somewhere else. It cannot happen nowhere. And something has definitely happened in the example provided by the Crown Agents. A mortgage portfolio has been refinanced, which is no small deal. But if the trade did not take place in Jersey, and the management was not in Jersey, then it must have been somewhere else, or someone is living in a make believe world. So where could that “somewhere else be”?

In general the OECD suggests a company is considered to be taxable in a place if:

1. it is registered in that place;
2. it is managed or controlled there;

3. it has a branch or permanent establishment there;
4. it undertakes a trade there (which is usually the same as 3).

In this case the entities are all registered in Jersey. They are managed and controlled there; after all the directors and trustees are Jersey resident or at least meet there. Nothing these entities are doing can suggest they have established a branch or trade anywhere but Jersey. Everything they do takes place in Jersey. Indeed, we know that they do trade in Jersey because Jersey Finance, the industry representative in Jersey said in a letter dated 3 December 2004 said:

The activities of these vehicles are broad and often complex. It is common for such vehicles to transact with each other, many provide services themselves and for many it is increasingly important for the activities to be undertaken from within the Island

This simply confirms the impression given by the Crown Agents. The provision of services must be a trade. It is hard to see what else it can be. And it is clear from this statement that it is widely known that they do trade from within the Island. And yet, in the preceding paragraph to the one quoted above Jersey Finance say:

They rely significantly on tax neutrality. Currently such vehicles are not required to file tax returns and are for the most part exempt from the scope of any form of taxation in Jersey.

In other words, although section 123 of the Income Tax Law makes all Jersey resident companies subject to tax unless they are exempt under section 123 A, and even then subjects them to tax if they undertake their trade through an established place of business in the Island, these trades which are known to be going on in Jersey, and are not taking place elsewhere, are apparently being ignored by the Comptroller of Income Tax in Jersey. That is apparently because despite the fact that these companies have no branches anywhere else, and only trade in Jersey, they are not taxable in Jersey because their directors can meet in Jersey without being deemed to be there, even though it is acknowledged that they are not anywhere else either. Section 123 (A) (9) and (10), in combination, create what seems to be a make believe world which is as transparent as the proverbial king's new clothes, but which the Jersey has projected as a credible basis for taxation. It's not hard to see why much of the world objected and, in addition, called such tax practices "harmful".

The only alternative explanation is that it is only the use of the "charitable trust" that allows this to happen. In that case exemption is given knowing that the transaction takes place in Jersey but with tax not being charged because the trust would ultimately be able to reclaim any tax paid. This, however, raises further questions:

1. who monitors these trusts?
2. who has benefited from them?
3. how can anyone be sure?
4. what level of funds is earned by them?
5. if, as would seem likely, the level of income they earn is high (after all, the transactions in SPVs are frequently large) how is profit extracted from the structures these trusts control to ensure they do not unduly benefit from them? This seems a necessary question because, as is noted, whilst a charitable structure is used for SPV transactions they are clearly not set up with charitable intent and therefore, presumably, it is ensured that most profit is recognised commercially.

Finally, of course, a question would have to be asked about whether the non transparent use of charity law in Jersey to allow non taxation in this case would itself be a breach of part B5 of the EU Code, as would seem to be the case if this reasoning were true because the charitable structure exempting a trading entity from tax would itself appear to be a ring fence, and one that is unlikely (given the proposed new anti avoidance laws to be applied to Jersey resident taxpayers) that is unlikely to be available to Jersey resident people.

Why is it important to discuss this?

This issue is important for several reasons:

1. it has not been widely known about in Jersey;
2. it needs to be known about in Jersey if its approach to taxation is to be understood;
3. the definition of who is, and who is not, resident and trades in Jersey is critical to the operation of the following two new taxes in Jersey:
 - a. the income tax charge at 10% on the financial services industry;
 - b. the new General Sales Tax.

Elements of the system noted above appear to be reproduced in the proposals for these laws and it therefore needs to be understood if they are to be properly assessed for their compliance with the EU Code of Conduct on Business Taxation. In addition, the mind set that created the existing tax system is also to be seen in the new tax laws and this therefore has to be taken into account in assessing whether they comply with the EU Code.

Chapter 3 - Jersey's new tax laws

Under Jersey's proposed new tax laws the exempt foreign companies referred to above and which form the basis for many of the SPVs used in the island will cease to be available, and will in time lose their tax advantages. Some other forms of tax advantaged company will also disappear. The following will happen instead:

1. all Jersey companies except those in the financial services industry will appear to be subject to income tax at 0%;
2. a new income tax charge will be introduced on the share of the taxable profit a Jersey resident person is deemed to have entitlement to in a company in which they own shares, wherever it is resident;
3. Jersey resident companies in the financial services industry will pay 10% income tax on their profits;
4. a new General Sales Tax is to be charged on almost all sales at 3% except that special arrangements are to be made to ensure that the contribution of the finance industry is limited to about £5 million per annum in total. The precise nature of this scheme is not known, but its likely structure is discussed below.

Since these arrangements are designed in response to the EU Code of Conduct on Business Taxation they have to comply with it or they fail to meet Jersey's objectives. The Code does make that clear.

The appearance of compliance

The new taxes appear to comply with the EU's requirements of Jersey because:

- the structures that it has ruled harmful will be abolished;
- the operation of one corporation tax rate appears to prevent suggestion of discrimination between resident and non resident companies;
- the charge of a higher rate of tax on one industry is allowed under the Code;
- the GST is a VAT and all member states of the EU have such a tax.

Simplistically, therefore, the new tax laws appear to meet the EU's requirements. The reality is that when the detail is considered none of the major new tax laws that are being introduced appear to actually comply with the Code. These issues need to be looked at in turn.

Tax on Financial Services Companies.

There is no doubt that it is intended that Jersey resident financial services companies will pay tax in the future. Because this only appears to be a modification of the existing regime for these companies this is the first issue looked at.

The proposals for this sector from the States of Jersey say:

- financial services companies licensed by the Jersey Financial Services Commission in Jersey will pay tax at 10% on their chargeable profits;
- this will be the case whether they are owned by Jersey residents or not.

In fact, all that would appear to be happening is that the rate for these companies is being changed from 20% to 10%. However, the new law is not quite what it seems. There are two reasons why this is the case. First of all, considerable numbers of the SPVs created by the finance industry in Jersey provide financial services in Jersey, as has been noted in the preceding chapter. As has also been noted, they undertake trades which in many cases can only be described as relating to the provision of financial services. Those SPVs have been deemed to be not resident in Jersey to date and have therefore avoided a charge to tax in the Island. If, however, the tax laws for exempt companies are abolished (as they must be) the provisions which have allowed these companies to be deemed to be non resident when they actually trade in Jersey will disappear as well. It would therefore seem likely that these SPVs should be subject to tax in Jersey in the future at the 10% financial services industry tax rate.

That, however, is not the plan. When the policy of taxing financial services companies was proposed to the States of Jersey the only reference to SPVs was³:

Special purpose vehicle companies used, for example, in 'off-balance sheet' financing, are typically owned by the trustees of a charitable trust and the company in question is commonly referred to as an 'orphan'. The profits made by the trustees are paid to charities or applied for charitable purposes so these profits will not be imputed to the Jersey resident trustees, or, where the trustee is a company, to that company's Jersey resident participators.

As this extract itself makes clear, these companies are Jersey resident. This is a necessary conclusion because they are owned by Jersey trustees and actually trade there. But in the policy of the States of Jersey approved on this issue in 2004 the following was said under the general heading of complying with the EU Code of Conduct:

In order to ensure that the providers of financial services can provide the products they need for their international customers, the facilities of the existing Exempt Company structure will be made available to residents as well as non-residents of the Island. This will be achieved by introducing a general rate of corporate profits tax in Jersey of 0%. This removes the discrimination between companies with resident and non-resident shareholders, and hence removes the threat of unilateral action by the U.K. and E.U.

However, in order to safeguard as much as possible of the tax revenue generated from corporate profits tax, those entities regulated by the JFSC, and a few others, will be excluded from the 0% rate and a higher rate applied to them. In particular the 10% internationally competitive rate will be applied to the financial services sector.

What this plan immediately creates though is the possibility that the location of the ring fence which defines whether a company, and most particularly an SPV, is taxed or not has moved from the realm of taxation legislation to that legislation which determines whether the Jersey Financial Services Commission has to regulate an entity.

Whether an entity is licenced by the JFSC is determined by the provisions of the Financial Services (Jersey) Law 1998. Section 2 of this Act appears to define what financial services are quite comprehensively. However, section 3 goes on to offer exemptions from the definition of what a financial services business is. The section is short, and refers to two Schedules to the Act, the most important of which is part of Schedule 2, which says the following are exempt from the Act:

PART 2 – TRUST COMPANY BUSINESS⁸¹

18 Special purpose vehicle⁸²

An activity specified in Article 2(3) and (4) carried on by a special purpose vehicle.

Note: In this paragraph –

“1958 Order” means the Control of Borrowing (Jersey) Order 1958;⁸³

“partnership interest” has the same meaning as in Article 10(3) of the 1958 Order;

“relevant consent” means the consent of the Commission given under Article 1, 2, 3, 4, 9(1) or 10 of the 1958 Order;

“securities” includes trust interests, shares, units, any partnership interest, bonds, notes, commercial paper, debentures, debenture stock and instruments creating or acknowledging indebtedness;

“special purpose vehicle” means a person who has obtained a relevant consent and whose sole or principal activity is to participate in a scheme or arrangement that involves –

- (a) the making of a loan, the giving of a guarantee, or the entering into of a derivatives transaction;
- (b) the issuing of securities;
- (c) the securitisation, acquisition or repackaging of assets;
- (d) a capital markets transaction;
- (e) any other transaction the Commission may approve for the purposes of this paragraph; or
- (f) any transaction in connection with any of the foregoing;

“unit” has the same meaning as in Article 13 of the 1958 Order.

In other words, any transaction undertaken by anyone that the JFSC decides need not be licenced because it has deemed it to be undertaken by an SPV is not regulated in Jersey, even though the entity undertaking it might very obviously be undertaking the supply of financial services within that territory. This has some obvious consequences:

1. it suggests that the system of financial services regulation in Jersey may be discretionary;
2. it makes clear that the previous exemptions from tax in Jersey provided by Section 123 (A) of the Income Tax (Jersey) Law of 1961 will still be available to SPVs but that exemption will now be granted by the simple expedient of deciding that the 10% tax on financial services business in Jersey will not apply to them by reason of the JFSC deciding it does not wish to regulate them because it has decided they are an SPV.

To date SPVs have been deemed, as far as it is possible to determine, to be companies operating in the financial services sector in the main but which:

1. are not owned by Jersey residents;
2. supply services within Jersey but for the benefit of persons not resident in Jersey;

3. undertake a very limited range of transactions for which they are specifically incorporated, each of which may have little or no economic substance within Jersey despite taking place there;
4. are deemed not to be resident in Jersey despite meeting all the normal tests for being so including being incorporated there, holding all their director's meetings there and undertaking all their commercial transactions there.

If these criteria are to persist, and the frequently made statements that the SPVs created by the financial services industry will not be subject to the new tax regime can only mean that they must, then it follows that the new 10% tax regime for the financial services industry in Jersey will fail since individually and in combination these criteria cannot meet the standards set by tests B1, B2 and B3 of the Code. The discretion granted to the JFSC to deem any activity one undertaken by an SPV ensures that the new law will also fail test B5 of the Code.

Without radical overhaul of its financial services legislation, its attitude towards SPVs and discretion granted by legislation there appears little prospect of the currently proposed 10% taxation system for the financial services industry meeting the requirements of the EU Code because it quite clearly is designed to give some companies a competitive advantage with regard to taxation over others and that is not allowed under that Code.

There is, however a solution to this problem. Quite clearly being licenced by the JFSC is not an adequate definition of who and who will not be liable to the 10% tax rate. As such the definition will have to be narrowed down until there is a very high chance that no SPV would be covered, if it is, as seems certain, Jersey's intent that these should not be taxed. It is, for example, unlikely that the SPVs involved will be undertaking banking activity. They may also not be undertaking what Jersey defines as category one insurance business. It is likely therefore that these two categories of company could be taxed knowing that this would not affect the SPV market. The same is probably not true of any other categories of registration (other insurance, trusts business, investment business, fund & security issues), all of which appear to have strong overlaps with SPV activities. It should, however, be noted that this will undoubtedly reduce the total tax take from this sector because although banks are believed to contribute at least 75% of the sector's profits if they were to split their business into component parts much of that profit might fall into non taxed sectors. The same might also be true for some insurance companies. The certainty of complying with the EU Code does have a cost in this case.

An estimate of that cost is hard to make, but it is thought that at least £760 million of profits in the financial services sector in Jersey come from banking⁴. Some of this may fall under other categories of income if a charge were only to be applied to banking profits. Assume therefore that banks might make a profit of £600 million in future for these purposes. They would pay 10% on this sum i.e. £60 million. Currently companies pay £133 million of tax in Jersey (Source: Jersey Budget 2005/06). It is noted below that maybe £12 million of this comes from local resident companies. That leaves about £120 million paid by non resident owned but Jersey

resident companies. The shortfall in this sector if only banks are taxed in future comes to about £60 million, therefore. When the shortfall on International Business Corporations and Exempt Companies is added, amounting in total to £51 million (Source: Jersey Budget 2005/06) the shortfall in revenue is about £110 million. This is above the levels estimated by Oxera and the Crown Agents in their work. They did, however, expect tax to be paid at 10% on the remainder of the profits of the financial services sector. These might amount to about £450 million which at 10% might be £45 million, meaning a tax loss in their calculation of no more than £65 million, to which The States then added the income which it knew it was to lose by 2008 of up to £12 million (for reasons unspecified in page 40 of Fiscal Policy paper P44) to come to a loss of revenue of almost £80 million per annum.

If only banks were taxed in future this sum might rise to about £120 million (£110 million as above, plus the “other” lost income of £10 - £12 million). The States only have a plan to balance up to £100 million of lost funds, of which only £60 million is from taxes, the balance being from growth or savings. It is clear that to only tax banks would therefore require at least £20 million and maybe up to £40 million of additional taxes or charges to be found to balance the States books. This issue is dealt with further in chapter 4 below.

General Sales Tax

The problems with the General Sales Tax largely relate to the financial services industry and therefore it need to be considered next since the last section also dealt with that sector.

A GST is effectively a VAT. Much of its detail need not concern this paper. In principle a GST is acceptable to the EU. But, a key issue concerning the GST, being whether it should apply to the financial services sector and to the SPVs it has created, attracted much attention during the debate preceding the approval of a GST in principle in May 2005. That debate is worth looking at in some detail as it provides indication as to current thinking about taxation in Jersey.

First of all, it is important to note that Jersey is not subject to EU rules on its GST (which is almost certainly why it is calling it a GST when technically it is a VAT).

Second it is important to note that a GST or VAT need not be applied to the finance industry. These activities can be either zero rate or exempt for the purposes of this tax. The differences are:

1. if the activity is exempt it does not charge GST on its sales. But if it is exempt it cannot claim a refund of any GST charged to it. This tends to increase the cost base of the industry, potentially making it less competitive or less profitable. Neither is seen as attractive in Jersey although exemption is commonplace for financial services in many VAT systems. Exempt tax systems also tend to be a little complex to operate and Jersey is keen to avoid any admin burden for its financial services industry since limited regulation is seen as an attractive feature of its overall offering;

2. zero rating also means that an industry appears not to charge GST on its sales, but in practice that is not true. It does charge the tax, but it does so at 0%, so the charge is nil. The important difference between this and exemption is, however, that any GST charged to a company making zero rate supplies can be reclaimed by it from the government responsible for the GST. This means that the company bears no tax burden, but has some administration to do to reclaim any tax charged to it.

The attitude of Jersey Finance to these two options is interesting. In its comments of 3 December 2004 on the possibility of a GST in Jersey it said:

19. It is therefore essential that any planned GST is "tax neutral" to the Financial Services Industry and its customers. The only way to achieve this is by ensuring that financial services are "**zero rated**" or out of scope for GST purposes, and that the vehicles and structures we establish for our customers are entirely outside the scope of GST.

It therefore rejected the exempt option as this meant the finance industry bore cost. This was not acceptable to it. That is why it wanted the zero rate option. They rejected the exempt option for these reasons, which appear to have been accepted by the States:

20. As noted in the consultation paper, under any GST system financial transactions and services are typically 'exempt' or 'zero rated'. However, for Jersey's Financial Services Industry, granting an exemption to a provider of services without a credit for the GST borne is quite simply not an option. Apart from the potential GST cost in terms of tax paid on inputs by service providers, exemption introduces additional complexities for affected businesses: verifying the location of counterparties/customers to determine the correct liability, classifying services to determine if they are exempt and not taxable and carrying out "partial exemption" calculations to ensure that recovery of GST on costs is maximized. We need a system which is easy to understand and operate (and therefore does not impede new business) and which bears no significant cost either in the form of a tax on inputs or undue administration. It is our strong view that zero rating is the best way to achieve this. It is also worth noting that there is an increasing international trend towards zero rating financial services (for example, New Zealand, a developing international finance centre, has most recently gone down this route in order to stimulate growth of its financial services industry).

In practice it has not got that option. It has been decided that the industry (which makes profits of about £1,050 million a year) should bear a GST cost of about £5m. According to the Fiscal Strategy paper P44 approved by the States in May 2005⁵:

The simplified treatment for the Financial Services Industry would involve providers of financial services being registered for GST but with a scheme devised to establish a GST burden by reference to the type of activity and the customer profile of individual firms. Tax borne on inputs would be offset to determine a balancing liability/repayment. Their supplies would not be subject to tax and they would not be involved in partial exemption calculations (to determine their deductible input tax). The various suppliers of financial services (“vehicles”) that underpin much of the activity in the sector would be subject to special provisions that secure their existing tax neutral status.

It would appear that this option is being chosen because this will impose a smaller charge upon the sector than would be the case by exempting it from the tax altogether. The arrangement does not, however, meet the requirements of the EU Code for a number of reasons:

1. Whilst special schemes for particular industries do exist under EU approved GSTs (for example, the UK’s retail schemes for its VAT) and it is accepted that these can be individually negotiated to suit a particular company’s needs in exceptional cases, such arrangements are always designed to reflect the mix of tax rates on the products supplied determined on the assumption that the supply is made within the state. There is no provision to determine the liability mix on the basis of international supplies, the claim for which has to be made individually and be proved in each case. It therefore appears that any scheme based on this arrangement could be in contravention of the following clauses of the code:
 - a. clause B5 of the Code for offering too wide a discretion at administrative level and opportunity for abuse;
 - b. clause B1 of the Code for reasons of offering a tax advantage to non residents transacting with non residents;
 - c. clause B2 of the Code by creating a ring fence around domestic transactions.
2. Whilst a blanket exemption from being chargeable to the VAT of an EU state in which a person or company is resident can be obtained under EU VAT rules if it can be shown that supplies only occur outside that territory this is only possible if the consequence is to deny input tax that the registered person might have reclaimed in the territory of registration in respect of supplies made entirely elsewhere. But the Jersey scheme is not of this nature. It is intended that exemption from the tax should be given on the basis of an “end user relief”. But the end user in this case will not be outside Jersey. As the analysis in this paper shows, Jersey Finance, the Crown Agents and the States of Jersey all know that the SPVs created by the financial services industry in Jersey do trade in Jersey. And in the vast majority of cases they do not trade anywhere else. In other words, to offer an end user relief certificate in this case would be to simply say that part of the financial services sector in Jersey was exempt from the GST purely on the grounds that its owners are not resident in the Island. This is the creation of a ring

fence on the basis of residence of ownership and as such is clearly contrary to the provisions of section B2 of the Code. It may also contravene section B1 of the Code.

The preceding paragraph remains valid despite there being a concept of end user relief in EU VAT law. That concept is only used to grant relief from charging tax in highly specific circumstances and almost always relates to supplies to charities e.g. on the supply of lifeboats to the Royal National Lifeboat Institution in the UK.

It should be noted that these problems with GST on the financial services industry would be entirely avoided if the industry as a whole was exempt from GST in Jersey. This would, however, increase the amount of GST probably paid by the financial services sector and might, in some cases, impose administration burdens on companies operating in this sector, including some SPVs. This, however, seems a necessary price to pay to ensure EU Code compliance.

Ring fencing in the proposed new income tax arrangements

The above analysis shows that the concept of ring fencing is still present in Jersey's taxation proposals for the financial services industry and the GST. It is, therefore, appropriate to see if that is also the case the proposed new scheme of income tax as it applies to non financial companies.

There appears to be little doubt that it is. As the 0 / 10 proposals for this tax regime make clear, the new 0% corporation tax rate on Jersey companies is not in fact any such thing unless the company is owned by persons not resident in Jersey. If the company has any shareholders resident in Jersey then the company is to be legally obliged to pay a sum equivalent to tax at 20% on its profits to its shareholders so that they may pay tax on those profits as if they were their own, whether or not all those profits have been paid to them. This provision is contrary to the requirements of the Code because:

- a. it creates an obligation on a resident owned company to pay a sum equivalent to tax that will not exist on non resident companies;
- b. that obligation will be calculated as if it were tax;
- c. the deeming of this liability to be that of the shareholder rather than the company does not alter the fact that this is a tax which will be charged on the profits of resident owned companies which will not be charged on non resident owned companies;
- d. the creation of any obligation (as is inevitable) to report the payment made to the taxation authorities including the provision of details of to whom it has been paid to enable those authorities to ensure that the sum paid as a dividend can be collected as tax from the recipients (as will surely be required) only proves that this is a tax in all but name, and therefore must be recognised as one;

- e. this law does apply to companies and does relate to tax and does provide companies owned by Jersey resident people with a competitive disadvantage when compared to companies that are owned by non resident people since the latter can accumulate all their profits at will if they so wish but companies owned by Jersey resident person cannot;
- f. it can only be presumed that this tortuous and complex process has been introduced to provide advantages to non resident companies that are ring fenced from the domestic market so they do not affect the national tax base.

As such this law reproduces the ring fence that exists under existing Jersey tax law which has largely ensured that only companies owned by Jersey residents have been taxed to date whilst companies owned by those who were not resident have, in the main, not been taxed. As such this provision clearly contravenes section B2 of the Code.

In addition, the inclusion of de minimis rules to allow the partial operation of this rule allows tax to be paid, or not, depending upon arbitrary rules which have inherent within them the possibility of the law being flouted in contravention of section B5 of the Code.

It should be noted that the Isle of Man has introduced a not dissimilar provision. If anything its provision even more clearly contravenes the code because the “look through tax” or “profits distribution charge” as they call it has to be paid direct by the company to the government; it need never be distributed to the shareholder. In consequence it would appear that its new taxation laws also fail the Code in this respect.

It is worth noting that Jersey (and other administrations introducing similar charges) think that the system they propose is not a business tax because they claim the tax is paid personally and therefore cannot be covered by the EU Code, which only relates to Jersey taxation. That would appear to be wrong. Charges for which liability arises within a company, and which are based on corporate profits must relate to business taxation, and whether or not the veil of incorporation is broken (and indeed, whether it should be broken or is even capable of being broken in this way, or not) this has to be the case. Accordingly the only way in which this tax might be considered a personal tax is by deeming it to be so. Jersey is used to deeming things to be other than they are in its taxation law as has already been noted in this report but the EU Code is not subject to such legal manipulation. That is because it is written on the basis of legal principles i.e. it is based on the substance of the issue and not its legal form. The difference is that the substance relates to what is actually happening, and the form relates to what the legal words used say is happening, with it being quite commonly the case that the two do not coincide in many jurisdictions. In this case the substance is that the tax is due on the profits of the legally incorporated business whoever is deemed by legal form to be liable to pay it and as such this is business taxation.

It is exceptionally difficult to see a way in which this problem can be circumvented. The simple fact is that a limited company has a separate legal personality from its shareholders. Any system that breaks down that divide for a selected group of shareholders defined solely on the basis of their residence appears to create a ring fence. When that ring fence acts to the detriment of resident owned companies to ensure the protection of domestic revenues, as is undoubtedly the case in the proposed “look through” tax in Jersey, then it is apparent that the EU Code has been broken.

The failure to impose this tax will have a cost. Total tax take from resident companies in Jersey in 2005/05 is expected to be about £133 million. Total financial services sector profits are expected to exceed £1 billion. It is clear many companies are not paying at the 20% tax rate as a result. It is also known that Jersey companies have relatively low profit rates, it being estimated by Oxera and the Crown Agents that 6% on turnover is about average. Based on States published Gross Value Added data for 2003 it is unlikely that all Jersey resident businesses excluding finance have turnover of in excess of £1 billion. In that case profits of £60 million might arise, leaving tax of £12 million that should have been paid and which might now possibly be lost per annum. This, incidentally, is a sum about equivalent to that paid by the self employed on their earnings in the Island. In practice it is unlikely all this will be lost since most people want income out of their companies at some point and will therefore pay salaries or dividends to achieve this. These will then be taxable if the recipient does live in Jersey, but the figure of £12 million is a useful benchmark for assessing this problem and will, therefore, be used.

Possible solutions to raising this income include:

1. taxing all companies only on their Jersey source income. This would however cause a significant problem because many of the SPVs have Jersey source income, and this presumably is why the option has not been proposed by The States;
2. looking for quite separate incentives to encourage distributions by Jersey companies to Jersey resident shareholders to ensure that dividends paid by Jersey companies fall into tax charge in their hands. Such possibilities might include:
 - a. removing the upper limits on social security contributions to encourage income to be paid as dividends, and
 - b. removing the monthly contribution limits for social security so that bonuses cannot enjoy low social security rates, so encouraging the payment of dividends;
3. only charging the resident population to tax on the dividend income they receive from companies unless it can be shown that they and their associates (including trusts and co-directors) control the entity in which they have an interest, whether resident or not, in which case a requirement to distribute would be in accordance with EU principles;

4. introducing the equivalent of the UK's "IR35" rules which says that if an employment is disguised as a self employment through the use of a limited company 95% of the income of the company must be paid by way of salary to the person undertaking the work of the disguised employment. If this is acceptable in the UK it seems unlikely it could be objected to in Jersey;
5. looking for other charges altogether to make up the shortfall so allowing Jersey owned companies to enjoy the same freedom as those not owned in Jersey, which is the one sure way to ensure that the ring fence is removed. Possibilities are:
 - a. an annual registration fee on Jersey trusts. The trust industry in Jersey makes profits in excess of £100 million per annum. Assuming a 40% profit rate which is not unreasonable, a turnover of at least £250 million per annum is likely. Fees of about, on average, £2,500 per annum per trust are common. This implies there must be at least 100,000 Jersey trusts. It is probably that the banks operate many more if the assumption that not all their profits arise from banking activities is true. It is, therefore, quite conceivable that there might be in excess of 200,000 trusts using the Island. None of these pay for doing so, and none pay any tax. An annual registration fee of, say £50 would generate an annual income of at least £10 million in this case. This would be less than the tax due at 10% on the profits of the trust companies that would now be tax free under the proposals made above for the finance industry. The compliance costs of such a regime, administered and paid entirely on line by Jersey resident professional people on behalf of the their clients, would be very low. It is very unlikely that the suggested annual charge would be high enough to dissuade anyone from using a Jersey trust as the fee is inconsequential compared to the professional fees usually levied for the operation of such a trust. Much of this cost will, in addition, be recoverable by this sector from clients as a disbursement, meaning the capacity for a larger fee could be considered to compensate for tax lost;
 - b. increasing the annual filing fee for all limited companies to a sum of at least £750 per annum equivalent to the annual current fee plus the £600 annual fee paid by exempt companies. There are about 35,000 live companies registered in Jersey in May 2005 (according to a telephone enquiry made of the JFSC). The additional revenue these companies, some of whom are already used to paying these sums would be about £21 million per annum;
 - c. it is noted that other proposals have been made elsewhere.

Chapter 4 - Why has Jersey made this mistake?

It is surprising that Jersey is introducing new tax laws designed to meet criticisms of its taxation legislation and practice made by the EU and set out in the EU Code of Conduct on Business Taxation and appears to have:

1. created proposals for new laws that also breach that Code;
2. not checked with the EU and UK to see whether this is not the case.

It does however appear to have created a range of proposed new laws that do breach that Code. In addition, it is now known that it has not asked the UK or EU for approval of its proposed new laws. This has been confirmed to the author of this paper by Senator Terry le Sueur and has been confirmed on BBC Radio Jersey by Senator Frank Walker, respectively Presidents of the Finance and Economics and Policy and Resources Committees, and the two people who should know. It therefore seems certain that this latter point is true.

There appear to be several reasons why this is the case:

1. Jersey was exceptionally reluctant to accept that the EU had any mandate on this issue in Jersey. It therefore seems possible that having finally been forced by the UK to accept this point Jersey does not now wish to acknowledge that fact by asking for approval for the changes that it is having imposed upon it;
2. It has simply not occurred to anyone to ask;
3. Jersey does actually think it is complying with the requirements of the Code;
4. Jersey is holding its breath and hoping that it is either complying or that by the time the issue is noticed the Code will have been forgotten.

Options 1 and 2 both seem likely. It is certainly true that genuine surprise has arisen when questions have been asked as to why EU approval for the new laws has not been sought.

Option 3 is also possible. This can be relatively easily explained. As is noted in the review of the “look through” and other provisions noted above it is clear that Jersey is used to laws that can be, and should be, taken literally even if the consequence is not logical. This means Jersey has an approach to law which emphasises the form of the wording of the law and the form that a transaction takes, regardless in either case of the substance that results.

The EU does not have this approach to law. The EU Code is a very good example of its approach to law. It is a statement of principles. Compliance is assessed not by the form of that apparent compliance but by assessing whether the substance of the response to the principles means that their spirit as well as their letter has been complied with. Precisely because this concept is so alien in Jersey those responsible

for the new taxes believe they complied with the Code because they have removed the activities named as being in contravention of it. It may not have occurred to them to make sure that the new laws comply with the spirit of the Code.

Unfortunately, it should have done, and that is because it seems unlikely that Option 4 will be viable. The EU has shown its willingness to expend political capital to make the EU Savings Directive work. There is no reason to think it will not also expend energy to make the Code work.

In addition, the Code does have provisions within it to ensure that compliance does take place. Each member state is required to ensure that it does not introduce new taxes that breach the Code. The UK has the responsibility to ensure that Jersey does not do so. Furthermore, any member state of the EU may ask the UK to investigate any new tax law that Jersey introduces and to supply it with information concerning that law so that it might determine whether it complies with the Code. Jersey should anticipate such requests. In this context the fact that Jersey has not asked the UK or the EU whether its new proposed tax laws comply with the Code exposes the Island to very considerable risk. The scale of that risk is explored in the next chapter.

Chapter 5 – Impact assessment

This paper has identified a number of areas where Jersey’s new tax laws do not comply with the requirements of the EU Code on Business Taxation. Most have a tax cost. One might have a tax benefit.

The States have assumed the tax loss resulting from the 0/10 policy is £80 - £100 million. This paper supports an analysis at the lower end of that scale, but for arguments sake a mid point is assumed for calculating the impact of the issues raised in this paper. That impact is as follows:

	£million
Loss as per States of Jersey from 0 / 10	90
Add, loss from restricting 10% tax to banking	45
Add, maximum loss from removing look through	12
Less, extra revenue from exempting financial services from GST	(5)
Adjusted deficit	142

Jersey cannot afford a deficit of £142 million. It is difficult for it to cover a shortfall of £100 million.

However, proposals in this paper show that there are other means of raising income to cover this deficit, as follows:

	£million
Additional fees from companies	21
Additional fees from trusts (probable minimum)	10
Likely tax paid on dividends not “looked through” (assume 60% distribution rate)	7
Introduction of an “IR 35” rule to stop blatant tax abuse (estimate)	2
Adjustments to social security (assumed not made)	0
	40

These adjustments bring the range of adjustments back into the range foreseen by The States at about £102 million.

There is however one other matter to consider. Jersey has £158 billion on deposit at present. Suppose at least 10% of this is subject to the European Savings Directive and suppose, as Jersey does, that many of those fund holders will opt for withholding taxes in 2005 onwards. This might mean that in each annual period from July 2005 onwards some £16 billion of deposits might be subject to withholding and tax might be deducted at 15% to which Jersey is entitled to 25%. Assume an interest rate of 4.5%.

Interest at 4.5% on £16 billion is £720 million. Tax on this at 15% is £108 million. Jersey's share would be £27 million.

It is reasonable to think that such a sum might be earned for each of the next three years. In that case the deficit on the States accounts might reduce to about £75 million. This means that an EU tax compliant tax system can be created within the parameters that the States have thought possible, and with a small margin (possibly) to spare.

Appendix I

The EU Code of Conduct for Business Taxation

**Code of conduct for business taxation
tax measures covered**

- 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 relaxed at administrative level in a non-transparent way.

Appendix 2

Specific aspects of Jersey's taxation laws deemed unacceptable under the EU Code of Conduct on Business Taxation

- Tax exempt companies
- International Treasury Operations
- International Business Companies
- Captive Insurance Companies

¹ Bedell Cristin, Solicitors, St Helier, Jersey.

² Crown Agents, January 2005, Page 37

³ States of Jersey P106/2004 p17

⁴ Crown Agents, January 2005, p36

⁵ States of Jersey P44/2005, p39