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BILLET D'ÉTAT

WEDNESDAY 27th JUNE 2012

TREASURY AND RESOURCES DEPARTMENT – REMOVAL OF DEEMED DISTRIBUTION REGIME[a]

[a]Accompanying Ordinance entitled "The Income Tax (Zero 10) (Deemed Distributions) (Repeal) (Guernsey) Ordinance, 2012"

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B I L L E T D'É T A T

TO THE MEMBERS OF THE STATES OF

THE ISLAND OF GUERNSEY

I have the honour to inform you that a Meeting of the States of Deliberation will be held at **THE ROYAL COURT HOUSE, on WEDNESDAY,** the **27th JUNE, 2012, at 9 30 a.m,** pursuant to Rule 1(4) of the Rules of Procedure of the States of Deliberation, to consider the item contained in this Billet d'État which has been submitted for debate.

R.J. COLLAS
Bailiff and Presiding Officer

The Royal Court House
Guernsey
25 May 2012

TREASURY & RESOURCES DEPARTMENT

REMOVAL OF DEEMED DISTRIBUTION REGIME

The Chief Minister
Policy Council
Sir Charles Frossard House
La Charroterie
St Peter Port

21st May, 2012

Dear Sir

1. Executive summary

1.1. In April of 2012, the European Union's Code of Conduct Group on Business Taxation ('CCG') provisionally determined that Guernsey's corporate tax regime was non compliant with the principles of the Code of Conduct on Business Tax ('the Code'). This followed presentation and discussion of a written assessment of Guernsey's regime by the EU Commission Services ('CS') prepared as part of the CCG formal review process of Guernsey's corporate tax regime. This determination is provisional but it is anticipated that it is just a formality that this decision will be ratified when presented to the Council of Finance Ministers of the European Union ('Ecofin') on June 22nd as part of the CCG's six month work programme update under the Danish Presidency.

1.2. The Bailiwick of Guernsey is not part of the EU. However, the States of Guernsey ('SoG') made a voluntary commitment to adhering to the principles of the Code following the agreement by the EU of the 'EU Tax Package' in December 2002. This report therefore concerns proposals to revise Guernsey's income tax regime to conform to the Code, and:

- outlines the chronology of the process and background to the CCG determination;
- provides an explanation of the CS assessment and CCG determination; and
- recommends the repeal of the deemed distribution provisions of the Income Tax (Guernsey) Law, 1975, ("the Income Tax Law") as amended, so that Guernsey's corporate tax regime conforms to the Code Criteria.

2. Background

2.1. In late 2009, the UK government communicated that certain Member States had concerns regarding the zero / 10 regimes of the three Crown Dependencies. The States of Guernsey resolved to commence a review of corporate tax in October 2009 (Billet d'Etat, XXIX). In May 2010, the CCG decided to formally review the zero / 10 regimes of Jersey and the Isle of Man, suspending the review process in the case of Guernsey.

2.2. The formal review of Jersey and the Isle of Man by the CCG focussed on the interaction of the deemed distribution and attribution mechanisms with the zero / 10 corporate tax regimes of those islands. In the assessment, the CCG determined that these regimes led to a deliberate current and structural method of taxation of business profits through the personal income tax system. It decided that the de facto effect of the interaction of the deemed distribution and attribution regimes was to 'ring fence' the zero rate so that it was available to non-residents only. On this basis the CCG ruled that Jersey and the Isle of Man had harmful regimes; a ruling endorsed by Ecofin in June 2011.

2.3. Jersey and the Isle of Man both committed to removal of their deemed distribution and attribution regimes and not to attempt to replicate the harmful effect by the introduction of alternative anti avoidance regimes in future: in the case of Jersey, legislation repealing the deemed distribution and attribution provisions was published (but not enacted) prior to the June 2011 Ecofin endorsement. In September of 2011, the CCG then determined that, having removed their deemed distribution and attribution regimes, the zero / 10 regimes of Jersey and the Isle of Man were no longer harmful. This judgement was endorsed by the European Council in December 2011.

2.4. The CCG then determined to resume the formal review of Guernsey's zero / 10 and deemed distribution regime. SoG staff were invited to attend the CCG meeting of February 2012 where they argued that Guernsey's deemed distribution regime was distinctly different to those of Jersey and Isle of Man, and did not create harmful effects. The argument that the regime was different to those of the other Crown Dependencies and should therefore be considered on its own merits was accepted, resulting in a formal assessment being prepared and presented by the CS to the April 2012 meeting of the CCG. However, the argument that the effect was different (and in any event outside of the scope of the Code) was not accepted by the CCG, and the regime was deemed to have a harmful effect and thus non-compliant with the Code.

2.5. In order to ensure that Guernsey continues to fulfil its commitment to comply with the principles of the Code, removal of the deemed distribution regime is necessary to remove the harmful effect (in the eyes of the CCG) of Guernsey's corporate tax regime.

2.6. Full Chronology of Code of Conduct Review Process

October, 2009

- Communication from UK that CCG considers the zero / 10 regimes to be against the 'spirit' of the Code.
- Crown Dependencies provide commitment to UK to review regimes (Guernsey does so through public resolution of the States).

March 2010

- Isle of Man publishes corporate tax consultation document.

May 2010

- CCG decides to formally review Jersey and Isle of Man regimes; formal review of Guernsey put on hold pending outcome of its corporate tax review.

June 2010

- Guernsey and Jersey publish corporate tax consultation documents.

August 2010

- Isle of Man publishes consultation feedback.

September 2010

- Formal description of Jersey and Isle of Man regimes (prepared by CS) presented to CCG.
- Jersey and Isle of Man present defence of zero / 10 regimes at CCG.
- CS directed to prepare formal assessment of Jersey and Isle of Man regimes against the Code criteria.

November 2010

- CS presents its formal assessment to CCG.
- Assessment states that zero / 10 regimes have harmful effect due to interaction of deemed distribution (Jersey) and attribution (Isle of Man) mechanism of personal tax regime with corporate tax regime de facto ring fencing the zero rate to non-residents.
- CCG agrees by consensus that this effect is harmful but consensus is not achieved that these aspects of the personal tax regimes are 'in scope' of the Code: a High Level Working Group ("HLWG") on Tax is commissioned to assess this question.
- Guernsey publishes provisional consultation feedback.

February 2011

- HLWG determines that the deemed distribution and attribution regimes are in scope of Code.
- CCG then confirms that Zero / 10 regimes of Jersey and Isle of Man are harmful according to the Code.

May 2011

- Jersey lodges 'amendment 38' repealing deemed distribution regime.
- Isle of Man announces abolition of its attribution rules.

June 2011

- CCG reports to Ecofin (Hungarian Presidency): report states that Jersey and Isle of Man regimes are harmful and welcomes proposals for 'rollback'[1]. It notes these measures will be assessed during next Presidency.
- Ecofin endorses CCG report and conclusions.

September 2011

- Rollback (i.e. repeal of deemed distribution and attribution regimes) of Jersey and Isle of Man regimes assessed.
- CCG determines that 'rollback' measures are sufficient to remove the 'harmful effect' and that the zero / 10 regime without such measures is compliant with Code, and by extension Jersey and Isle of Man regimes are compliant.

October 2011

- CCG decides to resume formal assessment process of Guernsey.

December 2011

- CCG reports to European Council (Polish Presidency): report states that Jersey and Isle of Man regimes are compliant.
- European Council endorses CCG report and conclusions.

February 2012

- Formal description of Guernsey regime is prepared by CS and presented to CCG.
- Guernsey presents defence of deemed distribution regime at CCG: argues that it is different to that of Jersey and Isle of Man; and that there is no harmful effect.
- CCG agree deemed distribution regime is different and requires a separate formal assessment: CS directed to prepare formal assessment against the Code criteria.

April 2012

- CS presents its formal assessment to CCG.
- CS assessment states that operation of Guernsey deemed distribution regime is different to deemed distribution and attribution regime of Jersey and Isle of Man but that effect the same, albeit with a timing difference. Determines therefore the regime is also harmful.
- CCG agrees assessment.

June 2012

- It is anticipated that 'harmful' CCG assessment to be presented in Danish Presidency six month work programme update to Ecofin for endorsement.

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[1] A Code Group term describing measures to remove harmful effects.

3. Commission Services' assessment of Guernsey's regime

3.1. Guernsey's case, presented to the CCG in February 2012, that the deemed distribution regime was different was accepted[2] (thus the separate formal assessment of its regime). Guernsey's case that its deemed distribution regime was sufficiently different for there to be no de facto ring fence, and thus no harmful effect, and that, given there was no current taxation of business profits (passive income aside), the deemed distribution regime is purely a matter of personal taxation was not accepted.

3.2. The summary of the formal CS assessment stated that:

> *"….similar deemed distribution provisions have been considered in the assessment of the zero/ten regime of Jersey and the ARI and DPC regimes of the Isle of Man. The only significant difference is that the deeming provisions in the case of Guernsey companies earning non-investment income do not depend on the non-distribution of profits in a given year. Instead, they are subject to the occurrence of an event which affects the latent tax claim of Guernsey. This is effectively only a timing difference."*

3.3. The CCG judgment is that Guernsey's regime is harmful, as was the case for Jersey and Isle of Man, as it effectively ring fences the zero rate. The ring fencing occurs through the interaction of the deemed distribution regime and the zero rate.

3.4. The CCG has determined that a zero / 10 regime on its own without either deemed distribution or attribution provisions is Code compliant and that a zero rate is not, of itself, harmful. Ecofin endorsed the ruling that the zero / 10 regimes of Jersey and the Isle of Man, having removed their deemed distribution and attribution regimes and confirmed that no attempt would be made to replace those provisions with another regime which replicated their effects, were determined to be Code compliant in December 2011. During Guernsey's review process the UK government has repeatedly made the point to other Member States that the zero rate is not in itself harmful and that a zero / 10 regime without deemed distribution is Code compliant.

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2 Unlike Jersey and Isle of Man's historic deemed distribution regime where a tax charge arose if a certain percentage of profits were not distributed, under Guernsey's deemed distribution regime there is no automatic taxation of current undistributed profits and reserves of a company in which an individual holds a beneficial interest, except where investment income has been received by the company (similar to controlled foreign company provisions for companies which exist in a number of countries); a tax liability arises on activation of specific 'trigger' events (deemed distributions):

- the disposal, repurchase and/or redemption of a beneficial shareholder's shares in the company;
- the death of a beneficial shareholder;
- the beneficial shareholder ceasing to be resident in Guernsey;
- the dissolution or migration of a tax resident company;
- company amalgamations or re-organisations;
- where the Director of Income Tax makes an adjustment under the Law in order to counteract any avoidance, reduction or deferral of liability.

3.5. Therefore removing the deemed distribution provisions, and concurrently making a similar commitment not to attempt to replicate their effects through the introduction of a replacement regime, will ensure that the effects of Guernsey's regime is no different to Jersey and the Isle of Man and is the best route to ensuring the CCG swiftly reverses its assessment of Guernsey's regime.

3.6. Attached to this report is a draft Ordinance repealing the deemed distribution provisions. The Department believes that this is the necessary step to conform to the Code. UK Treasury officials have stated quite categorically that this move should, in their opinion, fully deal with concerns of the CCG and enable the regime to be fully compliant with the Code.

4. Financial considerations

4.1. Income from deemed distribution revenues totalled £4.2m in 2011. Prior to 2011, the split between income from actual and deemed distributions was not recorded but assuming the same split between actual and deemed distributions in 2010, revenues would have been £3.5m in 2010. Repealing deemed distributions could result in the loss of current revenue of around £3-4m from distributions income. There is likely also to be an accompanying small loss in social security contribution income.

4.2. However, some of this 'loss' should be viewed as a 'temporary' effect as most income will ultimately be distributed, though it is impossible to determine what the split will be between permanent and temporary loss with any reasonable degree of certainty. Further revenue loss may result following the removal of the deemed distribution chargeable events, such as those pertaining to sales of shares, company dissolution and migration, if this were to lead to significant behavioural change. The scale of this is impossible to quantify at this juncture.

5. Corporate Governance

In preparing this Report, the Department has been mindful of the States Resolution to adopt the six core principles of good governance defined by the UK Independent Commission on Good Governance in Public Services (Billet IV of 2011). The Department believes that all of the proposals in this Report comply with those principles.

6. Legislation

6.1. Following Royal Assent to the Income Tax (Zero 10) (Guernsey) Law 2007, the Income Tax Law was amended to introduce section 208C, which permits the States to amend the Income Tax Law by Ordinance. This is the process which will be used to effect the amendments proposed in this Report.

6.2. The Law Officers have been consulted about these proposals and the Ordinance repealing the deemed distribution provisions from the Income Tax Law is attached as the appendix.

7. Summary

7.1. The CCG has determined that Guernsey's corporate tax regime has harmful effects due to the deemed distribution regime. A zero / 10 regime on its own has been determined as compliant with the Code. The repeal of the deemed distribution provisions is therefore a move to ensure that Guernsey's corporate tax regime conforms to the Code. There is no intention to replace these provisions with another regime which replicates their effects.

8. Recommendation

8.1. The Department recommends the States to agree that the deemed distribution provisions are repealed, by way of the Ordinance accompanying this report, as the appendix[3], with effect from January 2013.

Yours faithfully

Deputy Gavin St Pier
Minister

Deputy J Kuttlewasher, Deputy Minister	Deputy G M Collins	Deputy M H Dorey	Deputy A Spruce

[3] The Approval of the Presiding Officer has been sought for this Report and accompanying Ordinance to appear in the same Billet D'Etat. The Presiding Officer has also agreed that the legislation accompanying this report "The Income Tax (Zero 10) (Deemed Distributions) (Repeal) (Guernsey) Ordinance, 2012", is published as an appendix to the Billet. The Treasury and Resources Department is grateful to the Presiding Officer for his consent in this regard. The wording of the Ordinance reflects the recommendation set out in this Report.

ANNEX

Proposed revisions to income tax legislation

This Annex sets out information which:

1. contains information justifying the need for legislation;

2. confirms how funding will be provided to carry out functions required by the new legislation;

3. explains the risks and benefits associated with enacting/not enacting the legislation;

4. provides an estimated drafting time required to draw up the legislation.

1. The need for legislation

The proposal contained in the Report is required to ensure that Guernsey's corporate tax regime is compliant with the Code of Conduct on Business Taxation.

2. Funding

It is not anticipated that additional funding will be required.

3. Risk and benefits

If the legislation to implement the proposals is not enacted, it is likely that, because Guernsey's tax regime will not be compliant with the Code of Conduct on Business Taxation, it will come under increased scrutiny from EU, and there is the possibility that individual Member States may consider unilateral action to prevent business flowing to Guernsey.

The benefit of enacting this proposal and legislation speedily is that Guernsey's corporate tax regime will remain compliant with the Code, which will assist the financial services sector in attracting business.

4. Drafting time

The legislation has already been drafted.

APPENDIX

The Income Tax (Zero 10) (Deemed Distributions) (Repeal) (Guernsey) Ordinance, 2012

The Income Tax (Zero 10) (Deemed Distributions) (Repeal) (Guernsey) Ordinance, 2012

THE STATES, in pursuance of their Resolution of the 27th June, 2012[a], and in exercise of the powers conferred on them by sections 203A and 208C of the Income Tax (Guernsey) Law, 1975[b] and all other powers enabling them in that behalf, hereby order:-

Amendment of 1975 Law.

1. The Income Tax (Guernsey) Law, 1975, as amended, is further amended as follows.

2. Section 39D(4)[c] is repealed.

3. In section 47E(1)[d] in the definition of "deemed income" paragraph (a) is repealed.

4. In section 60 -

(a) in subsection (1)(a) and (c) the words "or deemed to have been paid" are repealed, and

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[a] Billet d'État No. XVI of 2012.

[b] Ordres en Conseil Vol. XXV, p. 124; section 203A was inserted by Order in Council No. XVII of 2005 and section 208C was inserted by Order in Council No. V of 2011.

[c] Section 39D was inserted by the Income Tax (Guernsey) (Amendment) Law, 2009 (Order in Council No. IX of 2011).

[d] Section 47E was inserted by the Income Tax (Zero 10) (Guernsey) (No. 2) Law, 2007 (Order in Council No. VI of 2011).

(b) subsection (1B)[e] is repealed.

5. Section 62AC[f] is repealed.

6. In Chapter VIIIA of Part IV[g] for the heading to the Chapter ("Deemed distribution of income") substitute "Undistributed income".

7. In section 62A -

(a) for the heading to the section ("Deemed distribution of company profits and income") substitute "Undistributed company profits and income",

(b) subsection (1) is repealed,

(c) in subsection (2)(b) -

(i) for the word "previously" substitute "before the 1st January, 2013", and

(ii) after the words "this Chapter" insert "(as it had effect immediately prior to that date)",

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[e] Subsection (1B) of section 60 was inserted by the Income Tax (Zero 10) (Guernsey) Law, 2007 (Order in Council No. V of 2011).

[f] Section 62AC was inserted by the Income Tax (Zero 10, etc) (Guernsey) (Amendment) Law, 2009 (Order in Council No. VII of 2011).

[g] Chapter VIIIA was inserted by the Income Tax (Zero 10) (Guernsey) (No. 2) Law, 2007 (Order in Council No. VI of 2011).

(d) subsection (3) is repealed,

(e) in subsection (4)(b) the words "and the deemed distribution thereof" are repealed,

(f) in subsection (5) after the words "pursuant to this Chapter" insert "(as it had effect immediately prior to the 1st January, 2013)",

(g) in subsection (5)(a) the words "or deemed" are repealed,

(h) subsection (6) is repealed,

(i) in subsection (7)[h] the words "For the purposes of calculating the amount of a deemed distribution, and" are repealed,

(j) in subsection (7)(a) the words "or deemed to be distributed" are repealed,

(k) subsection (7)(b) is repealed, and

(l) subsection (7)(ii) is repealed.

8. Section 62B[i] is repealed.

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[h] Subsection (7) of section 62A was substituted by the Income Tax (Zero 10, etc) (Guernsey) (Amendment) Law, 2009 (Order in Council No. VII of 2011).

[i] Section 62B was inserted by the Income Tax (Zero 10) (Guernsey) (No. 2) Law, 2007 (Order in Council No. VI of 2011) and amended by the Income Tax (Zero 10, etc) (Guernsey) (Amendment) Law, 2009 (Order in Council No. VII of 2011).

9. In section 62C(2)[j] after the words "sections 62A and 81B" insert "(which sections shall continue to have effect for the purposes of this section as they had effect immediately prior to the 1st January, 2013)".

10. In section 81B[k] -

(a) in the heading to the section the words "and deemed distributions" are repealed,

(b) in subsection (3)(a)(ii)[l] the words "or where section 62A(6) applies," are repealed,

(c) in subsection (13) the words "and Chapter VIIIA of Part IV" are repealed,

(d) subsection (15) is repealed,

(e) in subsection (17)[m] after the words "only from the company's", insert "other income and", and

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[j] Section 62C was inserted by the Income Tax (Zero 10) (Guernsey) (No. 2) Law, 2007 (Order in Council No. VI of 2011).

[k] Section 81B was inserted by the Income Tax (Zero 10) (Guernsey) Law, 2007 (Order in Council No. V of 2011).

[l] Subsection (3) was substituted by the Income Tax (Zero 10) (Guernsey) (No. 2) Law, 2007 (Order in Council No. VI of 2011).

[m] Subsection (17) was inserted by the Income Tax (Zero 10, etc) (Guernsey) (Amendment) Law, 2009 (Order in Council No. VII of 2011).

(f) subsection (18)[n] is repealed.

Citation.

11. This Ordinance may be cited as the Income Tax (Zero 10) (Deemed Distributions) (Repeal) (Guernsey) Ordinance, 2012.

Commencement.

12. This Ordinance shall come into force on the 1st January, 2013.

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[n] Subsection (18) was inserted by the Income Tax (Zero 10, etc) (Guernsey) (Amendment) Law, 2009 (Order in Council No. VII of 2011).

(NB The Policy Council supports this report as a necessary measure to ensure that Guernsey's corporate tax regime conforms to the EU Code on Business Tax.)

The States are asked to decide:-

I.- Whether, after consideration of the Report dated 21st May, 2012, of the Treasury and Resources Department, they are of the opinion:-

1. That the deemed distribution provisions of the Income Tax (Guernsey) Law, 1975, as amended, are repealed, in the manner set out in "The Income Tax (Zero 10) (Deemed Distributions) (Repeal) (Guernsey) Ordinance, 2012" which is appended to this report, with effect from 1 January 2013.

2. To approve the draft Ordinance entitled "The Income Tax (Zero 10) (Deemed Distributions) (Repeal) (Guernsey) Ordinance, 2012", and to direct that the same shall have effect as an Ordinance of the States.