Jersey & Guernsey Law Review – October 2011

DEEMED DIVIDENDS, ZERO/TEN, JERSEY AND THE EU

Harriet Brown

The recent European review of Jersey tax legislation in relation to the zero/ten regime has led to the proposed repeal of certain anti-avoidance provisions implemented to protect tax revenues from Jersey residents under the new regime. The provisions, which are set out in detail below, represent some of the first targeted anti-avoidance provisions in Jersey. Their proposed repeal for all but a handful of tax years leaves Jersey in the potentially difficult position of trying to combat a deferral of tax by Jersey residents through zero/ten companies with the blunt instrument of the existing general anti-avoidance provision. Whether or not this can be used effectively to combat a deferral, as opposed to out and out avoidance, remains to be seen.

1. Introduction

1 The tax climate for offshore jurisdictions is now changing faster than ever, some may even say becoming more hostile than ever. The increasing pace of change is demonstrated by the relatively recent introduction of the zero/ten corporate tax regime ("zero/ten") in Jersey. Zero/ten was brought in, broadly, to allow for a regime taxing the vast majority of companies' income either at a rate of 0% or 10%. This was in order to maintain the beneficial tax treatment of the now-defunct international business company for non-resident shareholders. Under zero/ten, however, the 0% rate would also apply to companies with Jersey-resident shareholders and consequently it was felt necessary, along with the new rates, to introduce certain anti-avoidance provisions applicable to individuals resident in Jersey.

2 The regime was to be effective for 2009 and subsequent years. It is now the case, however, that certain aspects of zero/ten, namely the provisions in relation to the taxation of "deemed dividends" (the "DD provisions") and "full attribution" (the "FA provisions") (the targeted anti-avoidance provisions directed at combating avoidance by Jersey residents by use of a company subject to the 0% rate of income tax), will be removed from the legislation.

3 The background to the removal of these provisions is that certain EU countries complained that zero/ten was not compliant with the "spirit" of the ECOFIN code of conduct on harmful tax competition for business taxation (the "Code of Conduct"). Such complaints resulted in Jersey submitting to review of the zero/ten regime by the EU Code of Conduct on Business Taxation Group (the "Code Group").

4 On 15 February 2011, the Chief Minister announced that the DD and FA provisions would be repealed, because the review by the Code Group had indicated certain concerns in relation to those provisions, namely that they were likely to be considered "harmful". While the amendments which will be brought in are still to be finally approved by the Code Group, HMRC are apparently of the view that the removal of the DD and FA provisions should also remove any concern about the harmful effects of zero/ten.[1]

5 The agreement by Jersey to reconsider its corporate tax regime, along with the subsequent decision to amend the regime, on the basis of the Code Group's decision, is interesting for several reasons. The first is the agreement of offshore jurisdictions to comply with the sensibilities of larger jurisdictions. Secondly, the way in which this is causing aspects of traditionally "high tax" jurisdictions to creep into "low tax" jurisdictions. Zero/ten is a perfect example of this, because it marries the competing objectives and needs of Jersey domestically, with its need to participate as a trusted member of the international finance community.

6 The original introduction of the FA and DD provisions, which can be characterised as targeted anti-avoidance provisions, are a relatively new departure for Jersey, which has hitherto relied on cooperation between the Comptroller of Income Tax and the general anti-avoidance provision found in art 134A of the Income Tax (Jersey) Law 1961 ("ITJL"). While the FA and DD provisions are now likely to be repealed, they did (and for the years to which they will apply do) raise questions, the likes of which have taxed (no pun intended) the courts of England and Wales for decades. These include whether or not Jersey will, over time, come to adopt a more traditionally "high tax jurisdiction" approach to tax avoidance, or if reliance on art 134A will suffice. It also raises questions of the possible adoption of post-*Ramsay*[2] style purposive interpretation, or similar measures, which the

---

[1] See Report of the States of Jersey on the Draft Income Tax (Amendment No. 38) (Jersey) Law 201-, p 4.

[2] See *WT Ramsay Ltd v Commr of Inland Revenue* 54 TC 101.

adoption of avoidance tactics in the UK have promulgated in the UK courts.

7 It seems likely that the removal of the DD and FA provisions will precipitate the need for more targeted anti-avoidance provisions in the ITJL, or at the very least greater use of the general anti-avoidance provision currently found in the ITJL, art 134A.

2. The introduction of the DD and FA provisions

8 The Income Tax (Amendment No. 29) (Jersey) Law 2008 ("Amendment 29"), was registered by the Royal Court on 28 March 2008, but has effect according to its provisions. This provisions provide both for the taxation of "deemed dividends" and for "full attribution".

9 The purpose of the DD provisions, which are set out in the ITJL, arts 81B–81P, was to tax Jersey-resident shareholders on profits of certain Jersey companies (while non-resident Jersey shareholders are not taxed). The DD provisions have effect for the 2009 year of assessment and subsequent years (Income Tax (Amendment No. 29) (Jersey) Law 2008, art 47), prior to the amendment.

10 The FA provisions are found in ITJL, arts 85F to 85H. The FA provisions also have effect for the 2009 year of assessment and, prior to amendment, subsequent years.

11 The Income Tax (Amendment No. 38) (Jersey) Law 201- (the "38 Amendment Law") repeals, and provides transitional provisions in relation to, both the DD and FA provisions. Before going on to consider the method and consequences of the repeal under the 38 Amendment Law, I set out, in brief, the scope of the DD and FA provisions.

3. The scope of the DD provisions

12 The DD provisions apply to two types of companies: Jersey trading companies and Jersey financial services companies. Both are defined in ITJL, art 81B(1), which provides—

> "'Jersey financial services company' means a company to which Article 123D applies;
>
> 'Jersey trading company' means a company to which Article 123C applies and which is not—
>
> (a) a company subject to full attribution; or
>
> (b) a collective investment fund …"

13 This definition is not terribly helpful; in relation to a Jersey financial services company (an "FS Co") it directs the reader to art 123D and to art 123C for a Jersey trading company (a "JT Co"), but doesn't give any guidance as to what is a "company subject to full attribution" or a "collective investment fund", both of which are excluded from being a JT Co. The meaning of full attribution is discussed in para 0 below.

14 Article 123D does not define an FS Co, it is in fact a charging provision which provides for FS Cos to be chargeable to income tax at 10%. An FS Co is defined in art 3, which provides—

> "… 'financial services company' means any company that—
>
> (a) is registered under the Financial Services (Jersey) Law 1998 to carry out—
>
> (i) investment business,
>
> (ii) trust company business, or
>
> (iii) fund services business, as an administrator or custodian in relation to an unclassified fund or an unregulated fund;
>
> (b) is registered under the Banking Business (Jersey) Law 1991, other than a company registered for business continuity under that Law, pursuant to Article 9A of the Banking Business (General Provisions) (Jersey) Order 2002; or
>
> (c) holds a permit under the Collective Investment Funds (Jersey) Law 1988 by virtue of being a functionary who is an administrator or custodian mentioned in Part 2 of the Schedule to that Law …"

15 The DD provisions relating to FS Cos will, therefore, only apply to companies within (a)–(c). The companies mentioned in (a) and (c) are service providing companies which are required to be registered with the Jersey Financial Services Commission in order to provide regulated services. Such companies are likely to have Jersey-resident shareholders.

16 Again, art 123C is a charging provision which provides—

> "This Article applies to a company—
>
> (a) which is regarded as resident in Jersey, or which has a permanent establishment in Jersey; and
>
> (b) which is not a company to which Article 123D applies or a utility company …"

17 Article 123C causes such a company to be charged to income tax at the rate of 0%. Article 3 provides that the expression "trading company" should be construed in accordance with Schedule A1. This provides (at para 2):

> "(1) In this Law, 'trading company' means a company carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities.
>
> (2) For the purposes of sub-paragraph (1), 'trading activities' means activities carried on by the company—
>
> (a) in the course of, or for the purposes of, a trade being carried on by it;
>
> (b) for the purposes of a trade that it is preparing to carry on;
>
> (c) with a view to its acquiring or starting to carry on a trade; or
>
> (d) with a view to its acquiring a significant interest in the share capital of another company that—
>
> (i) is a trading company or the holding company of a trading group, and
>
> (ii) if the acquiring company is a member of a group of companies, is not a member of that group.
>
> (3) Activities do not qualify as trading activities under sub-paragraph (2)(c) or (d) unless the acquisition is made, or (as the case may be) the company starts to carry on the trade, as soon as is reasonably practicable in the circumstances.
>
> (4) The reference in sub-paragraph (2)(d) to the acquisition of a significant interest in the share capital of another company is to an acquisition of ordinary share capital in the other company—
>
> (a) such as would make that company a 51% subsidiary of the acquiring company; or
>
> (b) such as would give the acquiring company a qualifying shareholding in a joint venture company without making the 2 companies members of the same group of companies."

18 This, however, is not what is apparently meant by "trading company" in the context of art 81B. In practice it seems probable that a JT Co and a trading company within Schedule A1 will largely be the same companies.

19 A charge to tax is made in relation to ordinary shares in a JT Co by art 81D and in an FS Co by art 81G. Article 81D provides—

"(1) This Article applies to an individual resident in Jersey who, at any time during a relevant financial period of a Jersey trading company, owns more than 2% of the ordinary share capital of that company.

(2) The individual shall be deemed to receive a dividend out of the relevant profits of the relevant financial period.

(3) The dividend shall be deemed to be received by the individual—

(a) as an interim dividend and a final dividend, in accordance with Articles 81E and 81F, where the relevant dividends paid or issued out of the company's relevant profits for the relevant financial period have an aggregate value which is less than the prescribed percentage of those profits;

(b) as a final dividend, in accordance with Article 81F, in any other case.

(4) The States may by Regulations—

(a) amend the percentage mentioned in paragraph (1);

(b) prescribe a percentage for the purposes of paragraph (3)(a)."

20 Thus the mechanism for charge is set out across two articles in addition to art 81D. What art 81D does is to set out the framework for the charge. The elements that must be present for a charge to tax to arise are as follows—

(a) the shareholder must be an individual;

(b) the shareholder must be resident in Jersey; and

(c) the shareholder must hold more than 2% of the ordinary share capital of the JT Co.

21 In the rest of this article a shareholder conforming to these requirements will be referred to as a "JT Deemed Dividend Shareholder".

22 In relation to the JT Deemed Dividend Shareholder requirements, this takes away the concern for non-resident Jersey shareholders. Such shareholders will not be taxed on deemed dividends, and will in effect retain the beneficial tax treatment to which they were subject under the previous system under zero/ten.

23 The "prescribed percentage" mentioned in para 3(a) has been determined by the States under the Income Tax (Amendment of Law) (Jersey) Order 2008, and is 60%.

24 Article 81D(2) deems the JT Deemed Dividend Shareholder to have received a dividend out of the "relevant profits" of the "relevant financial period". Both terms are defined in art 81B. Relevant profits are defined in art 81B(1) as:

> "(a) in relation to a financial period of a Jersey trading company, the balance of the income, profits and gains on which the company is charged under Schedule D at the rate of 0% after—
>
> (i) the making of any deduction or the giving of any allowance or relief to which the company is entitled under this Law,
>
> (ii) the deduction of any amount paid, before the last day of the following financial period, out of such income, profits and gains as a dividend on preference shares in the company …"

25 Relevant profits are calculated by reference to the amount upon which 0% income tax is charged by Schedule D. The amount will, effectively, be the net amount of the amount so chargeable, less reliefs allowed by the ITJL and any actual dividends paid on a preference share. Relevant financial period means any period for which "a company does not pay or issue any relevant dividends out of its relevant profits; or for which a company pays or issues relevant dividends out of its relevant profits where the relevant dividends have an aggregate value which is less than those profits".

26 These definitions make it clear that the DD provisions should only bite where there isn't a dividend which is otherwise chargeable. The deemed dividends can be chargeable as either final or interim deemed dividends. The mechanism for each is set out in ITJL arts 81E and 81F. Broadly, an interim dividend will be chargeable to tax at the end of every financial period (to which the DD provisions apply) in which a company has made a profit which it has not distributed by way of dividend. A final interim dividend will be chargeable to tax where a shareholding is terminated, whether by the winding up of the company, the sale of the shares, the company becoming subject to full attribution, the death of the shareholder or the shareholder becoming non-resident (presumably this is the shareholder becoming permanently non-resident, and not temporarily non-resident in accordance with art 126).

27 The charge on deemed dividends of an FS Co, is similar, but not identical to, that on a JT Co. The major difference is that there are not separate computations for interim and final deemed dividends—see, ITJL, art 81G. Paragraph (1) applies the deemed dividend provision to the same shareholders in FS Cos as in JT Cos. It is the circumstances

under which a dividend is deemed which are different. Paragraph (3) provides that a dividend is only deemed, in the case of an FS Co under the circumstances that a final dividend is deemed for a JT Co.

28 In either case, the provision is designed to prevent non-resident shareholders from being taxed in Jersey, while at the same time ensuring that the profits of the Jersey resident company are brought within the charge to Jersey income tax. The bringing into charge to tax the profits of companies which are not distributed to Jersey resident shareholders prevents the stockpiling of income in companies subject to 0% tax by Jersey residents.

4. The scope of the FA provisions

29 The scheme of the FA provisions is set out clearly in ITJL, art 85F. This provides—

> "(1) This Article applies to an individual resident in Jersey who, at any time during a financial period of a company subject to full attribution, owns more than 2% of the ordinary share capital of that company …"

30 Thus the only conditions for an individual to be chargeable under the FA provisions is that he is both Jersey resident and that during the financial period in question he owns more than 2% of the ordinary share capital of a company subject to full attribution.

31 ITJL, art 85F continues—

> "(2) Subject to paragraph (2A), a company is a company subject to full attribution if it is—
>
> (a) a company to which Article 123C applies; or
>
> (b) a registered person within the meaning of Article 118C and exempt from income tax under Article 118C(9).
>
> (2A) A company is not a company subject to full attribution if—
>
> (a) it is a trading company (other than a company limited by guarantee) or collective investment fund; and
>
> (b) less than 25% of the company's income, profits or gains comprise payments made pursuant to agreements with other persons for the supply of the services of an individual who owns shares in the company, or of an individual who is a person connected with an individual who owns shares in the company, in circumstances in which, but for the agreement and the interposition of the company, the other person and the individual would be employer and employee …"

32 Article 118C relates to eligible investment schemes. Article 123C is discussed at para 0 above.

33 ITJL, art 85F(3) provides for the charge—

> "(3) The individual shall be assessed and taxed at the standard rate on his or her portion of the company's relevant profits of the financial period, as if that portion was the individual's own income, profits and gains."

34 This causes the profits of a full attribution company to be treated as the income, profits and gains of the shareholders. This is similar to the approach taken in UK legislation in, for example, the Taxation of Chargeable Gains Act 1992, s 13 (which causes the gains of a non-UK resident company which would, if UK resident, be a close company to be treated as the gains of certain UK-resident shareholders of that company) and the Inheritance Tax Act 1984, s 94 (which provides for chargeable transfers of value of a close company to be apportioned to and chargeable on certain shareholders).

5. The amendments under the 38 Amendment Law: the DD provisions

35 The manner of dealing with the DD provisions is twofold. First, the liability under the DD provisions is limited to a certain period, and secondly, certain provisions are repealed.

36 In relation to the circumscription of the DD provisions the 38 Amendment Law, art 5 inserts new articles 81CA and 81CB into ITJL. These new articles provide:

> "**81CA Limitation of liability to taxation of deemed dividends from 2012**
>
> (1) Notwithstanding Article 81C(a), an individual shall not be liable to taxation under Articles 81D, 81E and 81F or under Article 81G in respect of relevant profits accruing to a company on or after 1st January 2012.
>
> (2) Notwithstanding Articles 81C(a), 81D(3)(b) and 81F, a final deemed dividend shall not be deemed to have been paid by reason of the occurrence of an event described in any of sub-paragraphs (a) to (e) of Article 81F, if the event occurs on or after 1st January 2012.
>
> (3) Notwithstanding Articles 81C(a) and 81G, an individual shall not be deemed to have received a dividend out of the relevant profits of a Jersey financial services company by reason of the occurrence of an event described in any of sub-paragraphs

(a) to (e) of paragraph (3) of that Article, if the event occurs on or after 1st January 2012.

81CB Modification of liability to taxation of deemed dividends on profits arising in 2011

(1) Paragraph (2) applies in the case of a company—

(a) in respect of which an individual may be liable to taxation under Articles 81D, 81E and 81F or under Article 81G; and

(b) which does not have a financial period ending on 31st December 2011.

(2) Articles 81D, 81E, 81F and 81G shall apply—

(a) in the case of a company that, on 31st December 2011, has not completed its first financial period, as if the period beginning on the day the company is incorporated and ending on the 31st December 2011 were the first financial period of the company;

(b) in the case of any other company that does not have a financial period ending on 31st December 2011, as if the period—

(i) beginning on the day following the end of the last financial period of the company preceding 31st December 2011, and

(ii) ending on 31st December 2011,

were a financial period of the company.

(3) Where—

(a) an individual is deemed to receive an interim deemed dividend out of the relevant profits of a company for the company's actual or deemed financial period ending on 31st December 2011; and

(b) apart from this paragraph, the last day of the following financial period of the company would fall after 31st December 2012,

Article 81E shall apply as if the last day of the following financial period of the company were the 31st December 2012.

(4) In this Article 'first financial period', in relation to a company, means the financial period beginning on the day the company is incorporated."

37 The purpose of these provisions is clear. The intention is to prevent profits accruing after 31 December 2011, or actions or events resulting in a final deemed dividend which occur on or after 1 January 2012, resulting in a deemed dividend charge.

38 Article 81E is amended by the 38 Amendment Law so that art 81E(4) provides—

> "Where the winding up of a company commences before the day that the interim dividend would be deemed to be received by an individual by virtue of paragraph (1), the interim dividend shall instead be deemed to be received by the individual on 31st December 2012 or, if earlier, the completion of the winding up of the company."

39 The remainder of the regime (*ie* arts 81B, arts 81CA and 81CB, and arts 81D to 81N) is repealed, but continues to have effect for the years of assessment 2008 (but in accordance with para 9 of Schedule 5 ITJL) and 2009 to 2012.

40 The amendment of the FA provisions is more straightforward. Articles 85F to 85H are repealed, and a saving provision is inserted into Schedule 5 of the ITJL. Paragraph 7 of Schedule 5 provides—

> "(1) Notwithstanding their repeal by Article 2 of the Income Tax (Amendment No. 38) (Jersey) Law 201-, Articles 85F to 85G shall continue to have effect for the years of assessment 2008 (in accordance with paragraph 6 of this Schedule), 2009, 2010 and, subject to sub-paragraphs (3) to (5), 2011.
>
> (2) The provisions of this Law amended by Article 3 of the Income Tax (Amendment No. 38) (Jersey) Law 201- shall continue to have effect, as they were in force immediately before the commencement of Part 2 of that Law, for the purposes of the continuing operation of Articles 85F to 85G.
>
> (3) Sub-paragraphs (4) and (5) apply in the case of a company subject to full attribution which does not have a financial period ending on 31st December 2011.
>
> (4) Article 85F shall apply—
>
> (a) in the case of a company that, on 31st December 2011, has not completed its first financial period, as if the period beginning on the day the company is incorporated and ending on 31st December 2011 were the first financial period of the company;
>
> (b) in the case of any other company that does not have a financial period ending on 31st December 2011, as if the period—
>
> (i) beginning on the day following the end of the last financial period of the company preceding 31st December 2011, and

(ii) ending on 31st December 2011,

were a financial period of the company.

(5) Article 85C(1) (as applied by Article 85F(6)) shall apply as if the operation of the rule in sub-paragraph (4)(b) were a change in the financial period for the company.

(6) In this paragraph first financial period, in relation to a company, means the financial period beginning on the day the company is incorporated."

41 Thus while the 38 Amendment Law is relatively complex, it really only provides for the eventual total repeal of the FA and DD provisions.

42 No doubt a great deal of expense and time has gone into first, the implementation of the FA and DD provisions, in order to comply with EU sensibilities, and subsequently in repealing the provisions. This can be seen as an indication as to how important political pressure is at present in the constantly shifting relationship between onshore and offshore.

6. The effect of the repeal for Jersey

43 One can only speculate on the precise effect of the repeal of the DD and FA provisions for Jersey, but in this section I aim to consider the likely outcomes and possible measures which could be taken to combat these effects.

44 First, to understand the importance of the repeal it is important to understand why the FA and DD provisions were introduced in the first place. Upon the change of the regime for the taxation of companies the scenario arose whereby Jersey residents would, absent the FA and DD provisions, be in a position to "shelter" income from taxation simply by leaving it in a company (which was subject to a rate of tax of 0% under ITJL, art 123C). It is this potential avoidance (though in reality, it represents merely a deferral, see below) at which the FA and DD provisions appear to be aimed.

45 The problem is, as mentioned, not one of outright avoidance, but more likely (and at the very least, in most cases), to be a deferral of tax. Once a company's income is paid out to Jersey resident shareholders it will be likely to become taxable on them (pursuant to ITJL, art 61(4)), and thus fall into the Jersey tax "net". The overall impact of the repeal of the FA and DD provisions from a Jersey tax perspective is that, in effect, nothing is taxable at the company level where ITJL, art 123C applies.

46 So what will be the net effect of this? It is, in fact, difficult to assess what the impact of both the deferral of income tax and the possible complete loss of revenue might be. Theoretically, the repeal should not be subject to abuse by way of avoidance which, while most likely possible, should be caught by ITJL, art 134A. This provides—

> "(1) If the Comptroller is of the opinion that the main purpose, or one of the main purposes, of a transaction, or a combination or series of transactions, is the avoidance, or reduction, of the liability of any person to income tax, the Comptroller may, subject as hereinafter provided, make such assessment or additional assessment on that person as the Comptroller considers appropriate to counteract such avoidance or reduction of liability:
>
> Provided that no assessment or additional assessment shall be made under this Article if the person shows to the satisfaction of the Comptroller either—
>
> (a) that the purpose of avoiding or reducing liability to income tax was not the main purpose or one of the main purposes for which the transaction, or the combination or series of transactions was effected; or
>
> (b) that the transaction was a bona fide commercial transaction, or that the combination or series of transactions was a bona fide combination or series of transactions and was not designed for the purpose of avoiding or reducing liability to income tax.
>
> (2) The provisions of this Law shall apply to any assessment or additional assessment made under this Article as if it had been made in pursuance of Part 5 …"

47 This is a potentially widely-worded general anti-avoidance provision. It has not been considered by the Jersey courts, and so it is not clear how either the Courts or the Comptroller will approach its application. Following the repeal of the FA and DD provisions the only way to combat this potential deferral of revenue streams is via the general anti-avoidance provision.

48 Where there is merely a deferral of tax, however, it is by no means certain that such a deferral would come within "the avoidance, or reduction, of the liability" to tax. On the basis of this argument there is a potential void left by the repeal of the DD and FA provisions.

49 Thus while there is a potential issue upon the repeal of the DD and FA provisions, this should only result in a deferral of tax. It is likely that any more serious attempt at anti-avoidance would be caught by art 134A. It will, however, be interesting to see how Jersey deals (either

with its existing legislation or by the enactment of new legislation) with the repeal of the short-lived FA and DD provisions.

7. Jersey and Europe: political pressure as a catalyst for legislative change

50 There can be no doubt that the changing attitudes towards taxation policy precipitated by the global financial crisis, has resulted in a new attitude to offshore taxation regimes. While it is true that these changes have been precipitated by political, as opposed to legal, pressure it is also the case that increasing pressure can, and is, being brought to bear on Jersey and similar jurisdictions.

51 The general anti-avoidance provision in ITJL, art 134A which may be inadequate to protect against a deferral of tax, it is likely to be sufficient to protect against more aggressive forms of tax avoidance, dependent on how it is utilised by the Comptroller, and interpreted by the courts, if required. The pressure, however, to remove the FA and DD provisions has left Jersey with a potential gap in revenue flows, caused by a present inability to bridge the gap between companies which are taxable at 0% and personal income taxable at, broadly, 20%. The significance of this gap, which remains to be seen, will hopefully not have a great impact on the financial well-being of the Island.

Harriet Brown is a barrister and Jersey advocate practising out of Tax Chambers, 15 Old Square. She is co-author (with James Kessler QC) of The Taxation of Charities *(8th ed) and joint managing editor of* The Personal Tax Planning Review *and* The Offshore and International Taxation Review.