

Guernsey's Zero-10 Income Tax Law Briefing

Introduction

On 1 January 2008, there was a fundamental change in the taxation of Guernsey companies.

Most companies that were previously exempt from tax (because they had non-Guernsey shareholders) can no longer apply for "exempt status". Instead a zero rate of income tax applies to these companies.

In fact, a zero rate of income tax now applies to all Guernsey companies, except banks and loan companies (who pay 10%) and companies deriving income from land and buildings in Guernsey and utilities (who pay 20%).

Investment funds can still apply for exempt status, even though they would pay tax at 0%, and there are reasons why they might prefer to do this.

For locally-owned companies, shareholders resident in Guernsey will be taxed on qualifying loans, distributions and, in certain circumstances, deemed distributions. A tax cap for Guernsey resident individuals has also been introduced, and the taxation of trusts clarified to the benefit of Guernsey resident settlors.

1. Why the change?

On 1 December 1997 the European Finance Minister's Economic and Financial Committee (ECOFIN) approved a three part package, which included a Code of Conduct on Business Taxation. The Code was aimed at eliminating harmful business taxation measures which favoured non-resident businesses over resident businesses. A prime example was Guernsey's system of taxing resident companies at 20% on worldwide income, but exempting companies wholly owned by non-residents and having no Guernsey source income. This system was considered harmful as it served to attract business to Guernsey solely on the basis of this tax treatment rather than for any commercial reasons.

The response of the States of Guernsey was to propose the introduction of a general corporate taxation rate of

0% with effect from 1 January 2008, in order to protect the interests of those companies already established in Guernsey and to maintain Guernsey as a jurisdiction of choice for the international finance industry.

The Income Tax (Zero - 10) (Guernsey) Law, 2007 and the Income Tax (Zero - 10) (Guernsey) (No 2) Law 2007 introduced the relevant changes to the Income Tax (Guernsey) Law, 1975 (as amended) (the "Law"). The amended Law imposes the new corporate tax rates, the tax on distributions and deemed distributions and a concept of taxable qualifying loans, and introduces the tax cap for individuals and changes to trust taxation. At the same time, the amended Law grants the Administrator of Income Tax (the "Administrator") more flexible powers to trace income into the hands of its owner and to make adjustments as required to a person's tax liability.

2. Rates of Company Tax

Until 31 December 2007 Guernsey had one rate of income tax - a standard rate of 20% applicable to companies and individuals - and an option for exemption for certain classes of entity. For individuals, this rate has not changed. Since 1 January 2008, however, companies have various options - certainly more than the two suggested by the "Zero-10" branding of the new regime. In fact, there are three rates of taxation and an exempt option depending on the source of a company's income and the residency of its shareholders:

- a standard rate of 0% on all income (save as noted below) applicable to Guernsey companies generally;
- an intermediate rate of 10% on all income from Banking Business (as defined below);
- a company higher rate of 20% on income earned from the regulated activities of utility companies and income derived from the ownership of land and buildings in Guernsey; and
- an exemption from income tax for companies which fall within category B or C of the Income Tax (Exempt Bodies) (Guernsey) Ordinance, 1989, that is collective investment schemes registered in Guernsey and those registered outside Guernsey

which have no Guernsey source income (except a bank account).

2.1 Zero

For Guernsey resident companies all that changed on 1 January 2008 was their standard rate of income tax - reduced to zero - and the treatment of distributions to members. Some companies experienced more of a change. The Category D and E exempt companies (Category D were, usually, companies set up as holding companies as part of group structures or securitisation vehicles and Category E were captive insurance companies) woke up on the first day of 2008 as tax-residents. For tax-resident companies, income from businesses (other than banking business, regulated utility business or the ownership of land and buildings), offices and employments, and other sources is charged to income tax at the company standard rate of 0%.

2.2 Ten

For the purposes of the Law, "Banking business" is defined as business carried on by an institution which is licensed under the Banking Supervision (Bailiwick of Guernsey) Law, 1994 (the "Banking Law") as a deposit taker and any business that, in the usual course of its business, provides or makes available credit facilities. "Credit facilities" is defined as the making of any advance or the granting of any credit to customers and includes the provision (in connection with the supply of goods by hire-purchase, conditional sale or credit sale), of credit in instalments for which a separate charge is made and disclosed to the customer, and any assignment to the business of an advance or credit repayable to a third person. "Customers" is not a defined term. "Income from banking business" is defined as income from the reinvestment or utilisation of customer deposits, income from the use of the entity's minimum regulatory capital required by the Banking Law and income arising from the provision or making available of credit facilities. Income from banking business is taxable at the company intermediate rate of 10%.

2.3 Twenty

Utilities and property holding companies are charged tax at 20%. However, the higher rate of tax applies only to monies received from the relevant income stream, so companies which have multiple income streams will

be charged tax at 20% only on income from activities regulated by the Office of the Director General of Utility Regulation or on income derived from ownership of land or buildings in Guernsey.

2.4 Exempt

Although exempt companies were deemed to be one of the harmful business tax measures, Guernsey was only obliged to rescind the legislation that related to Category D and E exempt companies. Collective investment schemes under Category A (Guernsey unit trusts), Category B (Guernsey investment companies and their wholly-owned subsidiaries) or Category C (companies or limited partnerships registered outside Guernsey or their wholly-owned subsidiaries) may continue to make an annual application and pay the £600 exemption fee.

2.5 Exempt v. Zero

Some collective investment schemes may decide that paying 0% is their preferred option. However, if they elect for exempt status, they will avoid the deemed distribution rules applicable to Guernsey resident companies; shareholders of exempt companies are only taxed when they actually receive a distribution. Further, companies subject to tax at 0% will have a number of reporting obligations, which will be avoided by exempt companies. Finally, there is a perceived marketing advantage for collective investment schemes which can promote themselves as tax-exempt in that investors will often perceive a tax-exemption as being more durable than 0% tax-residency, because it is thought to be easier for the authorities to increase the latter than to change the former.

3. Distributions and deemed distributions

Profits earned by companies which have not been taxed at the company higher rate of 20% are taxed when they are distributed by the company. In order to prevent company owners rolling up profits in zero-taxed companies, in certain circumstances profits are deemed to be distributed and taxed accordingly.

Amendments to the Law have broadened the scope of tax charged when companies dispense income to company members. The Law now imposes tax on "distributions", which are defined to cover any distribution made out of the assets of a company, and

includes dividends. However, the Law goes further to impose a charge on deemed distributions. The repayment of capital invested in a company by its shareholders is excluded, as is the repayment of funds borrowed by a company. Shareholders will be taxed at 20% on all distributed and deemed distributed income.

In the following circumstances, section 62A of the Law deems a company to have distributed to a beneficial member (or his representative) his share of any undistributed income which would have been payable to him had the company distributed all that income:

- immediately prior to the date of a disposal, repurchase, or redemption of a beneficial member's shares in the company;
- immediately prior to the date of the death of a beneficial member (subject to any relief by way of deferral of tax);
- immediately prior to the date of a beneficial member ceasing to be resident in Guernsey;
- immediately prior to the date of the migration of a Guernsey company out of Guernsey;
- immediately prior to the date of the amalgamation of a company;
- immediately prior to the date of the dissolution of a company;
- in the case of undistributed investment income arising or accruing to a company, on the last day of the calendar quarter in which it arose or accrued;
- immediately prior to the date of the permanent cessation of the whole, or substantially the whole, of a company's business (subject to any relief by way of deferral of tax); or
- there shall be deemed to have been distributed any other undistributed income in respect of which the Administrator has, pursuant to section 67 (anti-avoidance provisions), made an adjustment as respects the liability of any person to tax in order to counteract any avoidance, reduction or deferral of liability.

Income of any company which has arisen or accrued on or after 1 January 2008, which has not been distributed or deemed distributed, is included but income which has been taxed at the company higher rate of 20% (or at any equivalent or higher rate in another jurisdiction) is not considered undistributed income and is, therefore, excluded. Similarly, credit will be given for

deemed or actual distributions of any income which has been taxed at the company intermediate rate of 10%; the beneficial member will only be charged on the difference between that rate and the individual standard rate of 20%. The deemed distribution measures are effective from 1 January 2008, but losses incurred by a company prior to this date may be carried forward to be offset against future income. Undistributed company profits can also be carried forward for offsetting against company losses incurred subsequently. Companies will need to maintain current shareholder and beneficial member records so as to be able to track migrations, deaths and transactions between shareholders.

Distributions (deemed or actual) represent income in the hands of the beneficial members and are to be paid net of tax. The beneficial member is deemed to have received the distribution, irrespective of whether the distribution is actually made to another person. However, where that other person is resident in Guernsey, he may elect to be assessed for the income tax on such distribution in place of the beneficial member. "Beneficial member" of a company is defined as an individual who has a beneficial interest (or part thereof) in a share and includes individuals who hold an equitable interest or contractual interest in such share. In determining whether an individual holds a beneficial interest, the interest may be traced through any number of partnerships, trusts, companies, agreements or other arrangements.

Where any distribution is made, the company must make a quarterly return to the Administrator, giving details of the name and address of the person to whom the distribution is made, the date and amount of the distribution and the amount of tax paid.

The Law requires each company to deduct tax from distributions made and stipulates that agreements to make distributions without deductions of tax shall be void. Non-residents (companies and individuals) are exempt from Guernsey income tax. As previously however, where a non-resident company carries on business through a permanent establishment situated in Guernsey, its profits derived from, or attributable to, that business will be chargeable.

Deemed distributions apply to Guernsey companies only, but Guernsey-resident shareholders of foreign companies will still be liable for actual and deemed distributions

from such companies, so will need detailed reports in respect of their shareholdings.

4. Loans to participators

Interest-free loans which are written off or rolled over indefinitely are an obvious way of avoiding the tax on distributions. In order to prevent this, the Law has introduced a tax on "qualifying loans".

Any loan made by a company the income of which is taxed at a rate less than the company higher rate (20%) to any participator or officer of the company, any person connected to a participator or officer, or any third party for the benefit of a participator or officer shall be a "qualifying loan". A qualifying loan is deemed to comprise income in the hands of the receiver of the loan and is taxable at 20%, whether the recipient of the loan is an individual or a company.

A "participator" in a company is broadly defined as any member of that company or any person having a share or interest in the capital or income of the company and includes (i) any person who owns, or is entitled to acquire, share capital or voting rights in the company, (ii) any loan creditor of the company, (iii) any person who owns, or is entitled to acquire, a right to receive or participate in distributions of the company or any amounts payable by the company (in cash or in specie) to loan creditors by means of premium on redemption, and (iv) any person who is entitled to secure that certain present or future income or assets of the company will be applied directly or indirectly for such person's benefit.

For the purposes of the Law, a person is "connected" to another person if there is a corporate, partnership, personal, or trust relationship between them, or there is a corporate, partnership, personal or trust relationship between one of them and a third person.

Where a qualifying loan is repaid in whole or in part within 6 years of being made, any tax paid in respect of the loan or the part repaid may be claimed back by the person who paid it.

At the end of each quarter in which a company makes a qualifying loan, it must make a return to the Administrator giving details of the name and address of the recipient of the loan, the date and amount of the loan, the date and amount of tax paid, the dates

and amounts of repayments of the loan and the amount of the loan outstanding at the reporting date.

5. Non-residents

It is proposed that the filing of company income tax returns will, from 2009, only require the submission of accounts and computations if there would ultimately be a Guernsey domestic tax interest in that company. A company will not be required to submit accounts and tax computations with its annual tax return if it can confirm that it (i) has no Guernsey employees (other than local directors); (ii) has no Guernsey resident beneficial members; (iii) is not carrying out any activities which are regulated by the Office of Utility Regulation; (iv) has not made any qualifying loans; (v) has no Guernsey rental or property development income; and (vi) does not carry out any banking activities. The administrative burden on companies wholly owned by non-residents will see little change, therefore, under the Zero-10 legislation.

As noted in the sections on Distributions and Loans above, Zero-10 effectively shifts the burden of paying tax on the profits of most companies from the company onto the shareholders. Although a non-resident is theoretically liable to Guernsey tax on most Guernsey sources of income, sections 47A – K of the Law provide that certain types of income are deemed to be disregarded for this purpose and the non-resident is only liable to tax on the disregarded income to the extent that he has already suffered tax on it. In other words, there is no additional tax to pay, over that paid at source.

Payments of distributions, interest, royalties and other income of a similar nature continue to be exempt of Guernsey income tax where made to an individual who does not carry on business through a permanent establishment in Guernsey and such payment is made by an exempt company. Non-Guernsey resident individuals and companies are, however, liable to tax on income from land and buildings in Guernsey.

6. Individual cap

Guernsey resident individuals continue to be liable to tax of 20% on their worldwide income. However, the Law has introduced an annual cap of £250,000 for individual taxation. Individuals who earn in excess of £1.25 million from overseas income, Guernsey bank interest, and

income from Guernsey collective investment schemes (category A, B or C exempt vehicles), therefore, will profit from the cap. For individuals who are resident in Guernsey for only part of the year, the cap is time-apportioned. The Law provides tracing powers to ensure that no Guernsey source income is included in income which qualifies for the ceiling.

7. Taxation of Trusts

Tax is only charged on Guernsey source income (but not bank interest) of Guernsey trusts where the beneficiaries are non-Guernsey resident. Statement of Practice M12 continues to apply, excluding foreign-source income and Guernsey bank interest from charge. Where there are beneficiaries resident in Guernsey, Guernsey tax is chargeable on the worldwide income of the trust. The rate charged is that of the person beneficially entitled to that income. If a settlor is Guernsey resident and the settlement is revocable (where the settlor or his spouse has not been irrevocably excluded from benefiting), the settlor is liable to tax on the income of the trust, which includes the income of underlying entities of the trust.

The Law now confirms that the settlor's residency is of no consequence where the trustees or beneficiaries are liable to tax in their own names because income is payable to Guernsey-resident beneficiaries under a revocable trust, or where income, which is payable during the lifetime of the settlor to or for the benefit of an unmarried infant child of the settlor, is deemed to be that of the settlor.

Amendments to the Law have inserted clarification of how the income of assets underlying a trust is to be dealt with. Income arising under or comprised in a settlement, or by virtue or in consequence of a settlement includes the income of any company or other entity, where that company or other entity is held by, vested in, or otherwise under the control of the trustees of the settlement. The holding, vesting or control may be traced through any number of entities or arrangements in order to ascertain whether income arises under or is comprised in a settlement.

The definition of "settlement" has been widened to include loans, advances and similar transfers of funds or other assets which will be repaid in money or in kind, but not including bona fide transfers made at arm's length. "Settlor" is now defined more widely to include any person who has provided or caused to be provided funds or other property for a settlement or for any entity owned or controlled directly by the trustees of the settlement.

As noted above in the section on Deemed Distributions, in order to ascertain the identity of the ultimate beneficial members of a company and trace through the income ascribed to them, trusts are disregarded. Equally, trace-through provisions are available to ascertain connections (through trusts or otherwise) when dealing with loans to participators.

8. Legal avoidance

The amendments to the Law include reinforcement of the Administrator's powers to trace income to its owner. The Administrator may make such adjustments to a person's tax liability as are considered appropriate to counter any avoidance, reduction or deferral of liability which might otherwise be effected through a transaction or series of transactions. Such matters as the parties to the arrangement, the actual timing of the arrangement and its intended effect (if any) need not be taken into account when applying the anti-avoidance measures.

9. Statements of practice

The Law now makes it clear that the practical guidance issued by the administrator can as statements of practice comes into force as and when decided by the Administrator. More importantly, the Law has clarified the force and authority of the statements of practice: they must be taken into consideration by the Administrator when exercising his function under the Law and they can be relied on in any appeal proceedings, including those in the Royal Court.

Zero-10 is a prime example of Guernsey moving with the times and responding to external influence whilst maintaining stability and flexibility and retaining its competitive edge in the finance industry.

This briefing can only provide a general review of this area. Legal advice should be taken with regard to individual circumstances.

If you have any queries regarding the information in this briefing or simply wish to discuss your specific needs please contact:

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