TREASURY DEPARTMENT

INCOME TAX DIVISION

MODIFICATIONS TO TAXATION STRATEGY

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TREASURY DEPARTMENT – INCOME TAX DIVISION

MODIFICATIONS TO TAXATION STRATEGY

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Executive Summary

The tax strategy evolved over a number of years following consultation on a wide front. An early look had been taken at double taxation agreements with their attendant problem of exchange of information as well as a new corporate tax system and simplification of income tax.

When the Isle of Man became involved in 1999 in the OECD's exercise on harmful tax practices it provided the ideal opportunity for that early work to be looked at from an international standards perspective. Together with that earlier work it led to a tax strategy that had at its heart: –

i. a corporate tax system with a 10% rate of tax for trading profits and a higher rate for investment companies;

ii. a commitment to exchange of information based on an OECD Model Agreement.

The proposals were announced in June 2000 and published and approval by Tynwald in October 2000 as a precursor to an early commitment in January 2001 to the work of the OECD.

The commitment to the OECD enabled attention to be focussed at an early stage on the more difficult of the other international tax initiatives, that involving the European Union. It is the outcome of that work that has significantly influenced the Treasury's thinking behind the proposed modifications.

The Isle of Man Government has always expressed concern over its involvement in taxation initiatives determined outwith the Island and into which it has had no direct input. Accepting, however, that it is inextricably linked to the EU tax package the issue has been how best to respond.

The key principles of fiscal sovereignty, economic stability and adherence to international standards remain fundamental to the Treasury's consideration of any taxation initiative. They were fundamental in the formulation of the taxation strategy and have remained so in the consideration of the proposed modifications.

A case could be made that the Island's fiscal sovereignty places it outside the EU initiatives and that it intends to remain with the existing tax strategy. But to do so could be disregarding an opportunity to fine-tune the existing strategy to create an even greater incentive to help restructure the economy and accommodate the loss of certain operations as they move to less costly countries such as India and China. This will equally provide a strategy more in keeping with the reputation the Island has gained for its modern and progressive regulatory standards.

After lengthy consultation with the private sector and detailed discussions with the UK Inland Revenue at officer level, the "do nothing" is not considered to be a viable option. The tax strategy should therefore be modified to provide for further reductions in the proposed rate of corporate tax down to a minimum of zero apart from defined regulated activities for which a higher rate should be applied. Estimated cost of the modifications has been set at £23m.

Subject to the level playing field concept, the tax strategy should also contain a commitment to the same measures on automatic exchange of information as EU member countries.

Tynwald approval is being sought in principle for the proposed outlined modifications to the taxation strategy. Detailed provisions will subsequently be set out in draft legislation and subject to the normal parliamentary procedure.

Main points:

i. **the existing tax strategy should be modified to meet the additional challenges of the EU tax package but within the three key principles of fiscal sovereignty, economic well-being and international standards;**

ii. **given the options available, the taxation strategy should be modified to accommodate a zero rate of corporate tax with a higher rate for defined regulated businesses;**

iii. **subject to the level playing field concept, the tax strategy should contain a commitment to the same measures on automatic exchange of information as EU member countries;**

iv. **taking all factors into account, apart from new or increased business, the estimated cost of the proposed modifications will be approximately £23m;**

v. **the legislative programme should contain provisions which will enable the implementation of the proposed modified tax strategy by 31 December 2005.**

1. INTRODUCTION

1.1 Reason for Tax Strategy

In June 2000 the Treasury announced a new taxation strategy and in October 2000 Tynwald approved its introduction. The Treasury Minister in moving the motion explained that it was designed to position the Isle of Man in the medium to long term. It was based on the best assessment at the time of the future strength of the domestic economy, the global economy and changes in the external commercial and political environment. The Minister went on to emphasise that it was designed to secure the future economic well-being of the Island's community by sharpening the competitive edge of companies, helping to restructure the economy and meeting changing international standards.

The strategy contains a number of key changes designed to meet those objectives.

For businesses –

i. The introduction of a new corporate tax system designed around the accounting year of the company;
ii. A reduction in the standard rate for companies to 10% for trading profits with a higher rate for investment companies to complement the higher rate for individuals;
iii. A simplified approach to capital allowances;
iv. A start up scheme for new business allowing a phased approach to taxation;
v. Encouragement for inward investment;
vi. Removal of the ring fencing regimes around insurance, shipping and certain specific activities such as leasing.

For individuals –

i. A reduction in the standard rate of income tax to 10% and a 15% higher rate for those on higher incomes;
ii. A simplified basis of assessment for all income making it easier to understand and administer;
iii. A refundable tax credit system for those on low incomes;
iv. Encouragement for self reliance through pensions and savings initiatives;
v. Personal allowances for non residents.

Some of the proposals have already been met and others are in the process of being implemented. This progress is well in advance of the planned programme, scheduled for completion by the Budget of 2005. This earlier delivery has only been possible because of the continuing strength of the Island's economy, maintained in part by the strategy itself.

The tax strategy had been slowly evolving over a number of years and had involved consultation on a wide front including an early look at double taxation agreements with their attendant problem of exchange of information. When the Isle of Man

became involved in 1999 in the OECD's exercise on harmful tax practices it provided the ideal opportunity for that early work to be looked at from an international standards perspective. This led to the announcement of the tax strategy in June 2000, and its publication and approval by Tynwald in October 2000 as a precursor to an early commitment in January 2001 to the work of the OECD.

1.2 OECD initiative

This was initially concerned with lack of transparency, lack of exchange of information and predatory tax practices in relation to geographically mobile financial services. It eventually focussed upon effective exchange of information. The initial net for its exercise was cast over its own members and 41 other smaller jurisdictions involved in offshore finance.

Early commitments to the OECD standards were made by 9 jurisdictions including the Isle of Man. All but 7 of the originally listed jurisdictions, including Guernsey and Jersey, are now in the clear, mainly on account of having provided commitments but a few after having been reclassified as non-tax havens and some having to be "persuaded" that it was in their best interest to do so. The force of the UK position was certainly not lost on Jersey.

The tax strategy fully satisfies the OECD requirements, and the Isle of Man's early commitment, based on those proposals, enabled it to be removed from any potential OECD blacklist. It provided the certainty being looked for by those involved in international business and gave the Isle of Man the opportunity to further strengthen its international reputation by enabling it to play an active role in shaping the OECD Model Exchange of Information Agreement.

The OECD work is ongoing, particularly in the area of tax information exchange agreements. Consideration is also being given to the future role within OECD for all the committed jurisdictions.

1.3 EU Tax Package

The commitment to the OECD had the added advantage that it enabled attention to be focussed at an early stage on the more difficult of the other international tax initiatives, that involving the European Union. It is the outcome of that work that has significantly influenced the Treasury's thinking behind the proposed modifications set out in this document

The EU tax package consists of two separate initiatives, one relating to exchange of information and the second to harmful tax practices. Both are very similar to the OECD initiative but with some significant differences.

> ***Draft Savings Directive*** Its purpose is to set down a detailed framework that will provide for automatic exchange of information between member countries. The objective is to ensure that any interest paid by the financial institutions of one member country to a resident person of another member country is automatically forwarded to that persons taxation authority to enable the correct tax liability to be determined.
>
> i. The Directive is scheduled for formal adoption in December 2002 and will enter into force on 1 January 2004;
>
> ii. there will be a seven year transitional period for three countries (Luxembourg; Austria; Belgium) who will operate a withholding tax regime during the transition;

iii. by 1 January 2011 all members will be exchanging information automatically;

iv. in addition to member countries' dependent and overseas territories adopting the same measures, six other countries including the US and Switzerland have to adopt equivalent measures.

Code of Conduct The second initiative is the Code of Conduct on business taxation on corporate and non corporate bodies but not individuals. The objective, using criteria similar to the OECD exercise, is to identify and eliminate harmful tax measures across member countries and their dependent and overseas territories.

i. 250 such measures were initially identified of which 61 have been found to be harmful and have to be removed;

ii. work is already underway in member countries to remove their harmful measures and not allow any new companies to make use of them;

iii. all harmful measures have to be eliminated by 31 December 2005 although Belgium, Portugal and Luxembourg have applied for extensions of time for a few of their measures, Ireland already having an extension on its holding companies by virtue of the ruling under the state aid provisions;

iv. the Crown Dependencies and Overseas Territories have been identified as having 15, of which 6 are attributable to the Isle of Man;

v. the 6 attributable to the Isle of Man are –

International Business Companies

Non-Resident Company Duty

Exempt Insurance Companies

International Loan Business

Tax Exempt Managed Banks

Fund Managers Exemption.

2. RECONSIDERATION OF TAX STRATEGY

2.1 Why change needs to be considered

The Isle of Man Government has always expressed concern over its involvement in taxation initiatives determined outwith the Island and into which it has had no direct input. The Isle of Man is not part of the EU and only has a special relationship, via Protocol 3 to the UK's accession, in relation to free trade for goods but not services. Why then should the Isle of Man find itself involved in such an exercise?

The answer lies in the difficulties that EU member countries had in signing up to a tax package which could place them at a fiscal disadvantage compared with the financial centres of some of the dependent and overseas territories of their own members. Consequently, it became a condition of acceptance that member countries have to ensure, within their constitutional arrangements, that their dependent and overseas

territories adopt the same measures within the same timetable. It is worthy of note that the insertion of the constitutional relationship was at the request of the UK. Equally the UK has set its sights on ensuring the tax package does not fail or at least it does not fail because its dependent and overseas territories do not comply.

Accepting that the Isle of Man is inextricably linked to the tax package the issue has been how best to respond. The key principles of fiscal sovereignty, economic stability and adherence to international standards remain fundamental to the Treasury's consideration of any taxation initiative. They were fundamental in the formulation of the taxation strategy and have remained so in the consideration of the proposed modifications.

Clearly a case could be made that the Island's fiscal sovereignty places it outside the initiatives and it intends to remain with the existing tax strategy. This would, however, be ignoring the strength of feeling within the UK Treasury. It would also be ignoring the modern day reality of the true nature of sovereignty, wherein autonomy has continually to be compromised in the interests of securing international co-operation and retaining goodwill and access to markets.

For its own good reasons the UK considers the weight of argument for the tax package to be overwhelmingly in its own best interests and certainly a strong UK economy is in the best interests of the Isle of Man. There is also the possibility that the UK might wish to persuade the Isle of Man (and its other dependent and overseas territories) in the same manner that it persuaded Jersey to rethink its position over the OECD initiative. This could be viewed unfavourably by the very businesses the Treasury is seeking to retain and who responded so favourably to the "mature pragmatism of Government" in its approach to the OECD commitment.

But perhaps more importantly, to disregard the request, could be disregarding an opportunity to fine-tune the existing strategy by further simplifying the taxation system for all businesses. This could still accommodate the valuable business being conducted by the shipping, insurance and fund management industry whilst at the same time enable the permanent removal of the perceived harmful and predatory tax practices. It could create an even greater incentive to help restructure the economy and accommodate the loss of certain operations as they move to less costly countries such as India and China. Finally, it could be in keeping with the reputation the Island has gained for its modern and progressive regulatory standards.

After lengthy consultation with the private sector and detailed discussions with the UK Inland Revenue at officer level, the "do nothing" is not considered to be a viable option.

2.2 *Recommendation*

Treasury recommends that the existing tax strategy be modified to meet the additional challenges of the EU tax package but within the three key principles of fiscal sovereignty, economic well-being and international standards.

3. OPTIONS

3.1 Code of Conduct

In considering the options available, Treasury recognises that there will be a cost to making modifications to meet the code of conduct requirements but equally there is a cost to doing nothing. The need to retain the legitimate business being conducted

through the current exempt regimes has been made quite clear in the consultations with the business community. For example the two principal exempt activities (life insurance and ship management) together account for around 2,500 jobs, whilst exempt company vehicles provide a very significant volume of high margin business to the accounting and legal services sectors on the Island. The full extent of the damage that would be incurred from the removal of a zero tax rate from our direct tax regime in these areas would be immense. Moreover the losses would be mostly felt in areas of activity and employment that are profitable and wealth-creating, the kind of areas that any future economic strategy would wish to maintain and develop further.

Given the various fiscal and international constraints, the options available are few and point to either the introduction of a territorial tax system or a move to a standard zero rate of tax for all business activities apart from a few within a defined regulated business sector such as the deposit taking industry.

A territorial tax system is based on the premise that the country only seeks to tax the income arising within its own fiscal boundaries. South Africa is a good example of a country that had such a regime but has abandoned it in favour of a worlwide income approach. Experience has shown that it is open to abuse and tends to discourage inward investment. Conversely, Hong Kong still retains it but has similar problems with avoidance and in any event is heavily supported by its capital taxes.

A standard zero rate for all business activities, apart from a few within a defined regulated business sector such as the deposit taking industry, has a certain simplicity about it and it meets the international standards being set by both the OECD and the EU. The rate of tax may be highly competitive but the international requirements have not been about tax rates but about fair competition and the removal of harmful and predatory tax practices. It permits the retention of the insurance, shipping and fund management industries and retains the important concept of tax neutrality for international business. Inward investment is encouraged, restructuring is facilitated and local business, such as tourism, retail and construction, is assisted. In essence it is the existing strategy but taken a step further for companies.

3.2 *Recommendation*

Given the options available the Treasury recommends that the taxation strategy should be modified to accommodate the zero rate tax approach

3.3 Draft Savings Directive

The same three key principles referred to above apply equally to exchange of information. A commitment has already been made to enter into a tax information exchange agreement with any OECD country that requests one, and this obviously includes all EU member countries. The issue is therefore not one of whether exchange of information should take place but in particular whether a move to automatic exchange of information is more in keeping with true international standards than the Model agreement negotiated by the OECD.

For the present the Treasury is not convinced that automatic exchanges are the new standard. At the very least it would require the adoption and implementation by all member countries and equivalent measures by the significant third countries of Switzerland and the US. If this were to happen then the argument for change would be stronger.

Certainty is also required over the final text to be adopted and it is not unreasonable to look to the main elements of the text agreed at the ECOFIN Council of 13 December 2001 as the standard. This does not prevent negotiations taking place on a bi-lateral basis about a double taxation agreement that contains an automatic exchange of information Article in keeping with the adopted text.

Regard must also be given to the commitments already made by both Jersey and Guernsey and to the fact that the savings directive and code of conduct form a package.

3.4 *Recommendation*

Subject to the comments above, the Treasury supports the tax strategy containing a commitment to the same measures on automatic exchange of information as EU member countries.

4. COST OF THE MODIFICATIONS

4.1 Statistical Data - current available information:

i. estimated direct tax on all companies for the tax year 2002/03 is £60m;

ii. tax attributable to the regulated deposit takers is estimated at £43m;

iii. approximately 15,000 exempt companies currently pay fees of £7m;

iv. approximately 7,500 Isle of Man incorporated companies pay neither fee nor tax;

v. approximately 35,000 foreign incorporated companies administered via the Island pay neither fee nor tax;

vi. the value of the exempt company activities to the Islands economy is estimated to be at least £6,000 per company/trust per annum.

4.2 Savings Directive

This is difficult to ascertain with any degree of certainty. For example, the implementation of automatic exchange of information is still some way off but the fact that it is on the agenda will cause some deposits to be lost. Conversely, an exchange of information agreement can generate new deposits as the need for closer scrutiny of activities by another tax authority is likely to be diminished making the cost of compliance less.

4.3 Code of Conduct

The zero rate approach is a little easier to cost but here again the true cost will depend upon a number of factors. New business generated by the zero rate proposal will help reduce the cost. Conversely, if action is not taken to prevent slippage from out of the individual tax regime into the corporate zero rate the cost will increase. An increased licence fee on the non-tax paying regulated activities will decrease the cost. A fee on all non-tax paying companies, including those administered here but incorporated elsewhere will also reduce the cost.

It should not be lost sight of that the cost of making no changes and generally allowing the exempt company regimes to dwindle away is itself a costly option. Confidential research with a few of the leading professional firms suggests an exempt

company could on average generate at least £6,000 income per annum for the economy without taking into account employment and investment opportunities.

Taking all factors into account, apart from new or increased business, it is estimated that the cost of the proposed modifications will be approximately £23m.

The potential impact of such a reduction on Government's revenue expenditure has to be acknowledged, although through the corporate planning process, the Treasury is seeking to ensure that any reduction in income is accounted for by a phased diminution in future expenditure increases, as opposed to having to impose expenditure reductions.

5. IMPLEMENTATION PLAN

5.1 Phased approach

If accepted, the modified tax strategy will require a phased approach and could be implemented over the next four budgets ie 2003 to 2006. It may be possible to achieve this earlier if the level of public expenditure permits and the level of business activity remains buoyant. In any event the deadline for the removal of the harmful tax practices will require implementation of the zero corporate tax rate by 1 January 2006 at the latest.

5.2 Legislation

The existing legislative timetable will need to be amended to accommodate the phased approach and three Taxes Bills will be required. The modified tax strategy relies upon productive employment being maintained at a high level with all individuals paying their fair share of income tax. The integrity of the income tax system will be essential to the success of the proposals. This will require the introduction of new provisions designed to prevent that integrity being compromised. Other jurisdictions, such as Ireland with its growing differential between personal and corporate tax rates, have experienced a similar problem and lessons can be learned from their experiences.

The first of the Taxes Bills will need to be introduced in November 2002. It will contain measures to introduce tax credits and basic compliance with exchange of information commitments. Some initial anti-avoidance steps will be needed in relation to unacceptable use of directors' loan accounts.

The second Bill will feature the simplification of the basis of assessment to income tax for individuals and provide for a payment on account procedure that will maintain the current payment dates. This Bill may also contain the substantive provisions on anti-avoidance to coincide with the reducing tax rates on corporate activities. It will need to be introduced into the legislative procedure by late 2003 for implementation in the 2004/05 tax year.

The final Bill will contain the corporate tax system that will replace the existing income tax system for the taxation of companies. It will be implemented at the same time as the final move to a zero rate of tax for companies, planned for January 2006. This will remove the need for any complicated transitional measures.

By the time this process is completed the direct tax system will have been through a major transformation although inevitably there will be some measures still left in their

existing Tax Act. This will be the optimum time for an overall consolidation of the Taxes Acts.

6. FURTHER WORK

What is done within the tax strategy is integral to the evolving economic strategy. The latter is concerned with sustaining economic growth and raising living standards but through the greater development and encouragement of higher value added/less labour intensive activity and companies. By increasing the differential between IOM and other jurisdictions' tax rates there is much greater encouragement and direct financial incentive for companies to locate themselves here or divide up their activities such that the low labour intensive (ie low total labour cost) functions are conducted out of the lowest tax jurisdiction, thus maximising their net post-tax profits. This is something for which there is already clear evidence that it is happening in response to the tax strategy to date.

A taxation strategy is a living document. In this global environment it has to be constantly reviewed to ensure it remains in step with the economic changes taking place both domestically and internationally.

7. SUMMARY

The tax strategy evolved over a number of years following consultation on a wide front. At its heart it provides for –

i. a corporate tax system with a 10% rate of tax for trading profits and a higher rate for investment companies;

ii. a commitment to exchange of information based on an OECD Model Agreement .

The Isle of Man Government has always expressed concern over its involvement in taxation initiatives determined outwith the Island and into which it has had no direct input. Accepting, however, that it is inextricably linked to the EU tax package the issue has been how best to respond.

After lengthy consultation with the private sector the "do nothing" is not considered to be a viable option and the tax strategy should therefore be modified.

7.1 Main points:

i. the existing tax strategy should be modified to meet the additional challenges of the EU tax package but within the three key principles of fiscal sovereignty, economic well-being and international standards;

ii. **given the options available, the taxation strategy should be modified to accommodate a zero rate of corporate tax with a higher rate for defined regulated businesses;**

iii. subject to the level playing field concept, the tax strategy should contain a commitment to the same measures on automatic exchange of information as EU member countries;

iv. **taking all factors into account, apart from new or increased business, the estimated cost of the proposed modifications will be approximately £23m;**

v. **the legislative programme should contain provisions which will enable the implementation of the proposed modified tax strategy by 31 December 2005.**

7.2 Tynwald Approval

Tynwald approval is being sought in principle for the proposed outlined modifications to the taxation strategy. Detailed provisions will subsequently be set out in draft legislation and subject to the normal parliamentary procedure.