TREASURY & RESOURCES DEPARTMENT

PROPOSAL FOR THE ABOLITION OF RETENTION TAX

The Chief Minister
Policy Council
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7th September 2010

Dear Sir

1. Executive Summary

The Treasury and Resources Department ("the Department") proposes that, with effect from 1 January 2011, Guernsey banks, custodians and other economic operators who are treated as "paying agents" for the purposes of the arrangements that Guernsey has entered into with Member States of the European Union ("EUMS") may choose to move to full exchange of information, when making payments of the type that fall within the scope of the agreement, provided that all Guernsey paying agents must move to full automatic exchange by 1 July 2011. As a consequence, with effect from 1 July 2011, no Guernsey paying agent will have the option of deducting Retention Tax from interest payments made to their customers/clients who are residents of EUMS.

2. Introduction

2.1 EU Directive 2003/48/EEC, which is colloquially known as the "EU Savings Directive" (hereafter referred to as "EUSD") was effective from 1 July 2005, as were various bilateral agreements that Guernsey had entered into in order to bring measures equivalent to the EUSD into effect, between itself and the EUMS (hereafter referred to as "the EUSD equivalent agreements").

2.2 The main purpose of the EUSD and the EUSD equivalent agreements was to implement automatic exchange of information between EUMS, and also their associated territories (which includes the Crown Dependencies) and with certain third countries such as Switzerland, when a bank, custodian or other similar operator (a "paying agent") in one of the territories made a payment covered by the EUSD, and the EUSD equivalent agreements (hereafter referred to as “interest payments” to a resident of an (another) EUMS).

2.3 At the time, however, Austria, Belgium and Luxemburg (who were all EUMS) were allowed exemption from providing full automatic exchange in view of structural differences, which prevented them from doing so, during a transitional period. They were instead able to implement a system of withholding tax at rates which were to progressively increase as follows:

1 July 2005 – 30 June 2008	15%
1 July 2008 - 30 June 2011	20%
Thereafter	35%

2.4 Guernsey (together with the other Crown Dependencies) adopted this approach also, using the same rates and time lines, as did Switzerland. In Guernsey the process became known as Retention Tax. Whilst Retention Tax was the default requirement, there was also provision for beneficial owners of interest to elect for information to be exchanged with their home tax jurisdiction instead of suffering tax deductions.

2.5 The transitional period was to end only when the EU was satisfied that Switzerland, San Marino, Andorra, Liechtenstein and Monaco had arrangements in place which ensured effective exchange of information, on request, with respect to interest payments, and also that the United States of America (“USA”) was committed to exchange of information on request in respect of interest payments. (In practice, the EU accepted that the USA was so committed fairly early on in the process, so the only issue remaining was with the European third parties referred to above.)

2.6 The EUSD equivalent agreements provided that 75% of the Retention Tax collected was to be transferred by Guernsey to the EUMS in which the beneficial owner of the interest resided, and that territory was to give credit for the Retention Tax against any domestic liability. The remaining 25% of the tax collected was retained by Guernsey.

2.7 Since the implementation of the EUSD measures, Guernsey has collected:

2006	£ 4.8m, of which £1.2m was retained as Guernsey’s 25% share
2007	£15.3m, of which £3.8m was retained as Guernsey’s 25% share
2008	£16.2m, of which £4m was retained as Guernsey’s 25% share
2009	£14.8m, of which £3.7m was retained as Guernsey’s 25% share
2010	£ 6.5m, of which £1.6m was retained as Guernsey’s 25% share

(NB – the amounts received are in respect of retention tax withheld by the paying agent in the previous calendar year, i.e. the £6.5m received in 2010 was in respect of interest paid in 2009.)

3. **The move towards full automatic exchange**

3.1 In 2009, Belgium announced that it intended to move to automatic exchange of information from 1 January 2010, meaning it would no longer operate the withholding tax regime.

3.2 The Isle of Man has also now made an announcement that it intends to move completely to automatic exchange from 1 July 2011, again irrespective of whether or not the transitional period has come to an end by that time.

3.3 There may be a perception, internationally, that the deduction of Retention Tax beyond July 2011 at a rate of 35% (see 2.3 above) <u>may</u> suggest that the beneficial owners of the interest bearing such a rate of Retention Tax could be doing so as the income is not being disclosed to the tax authorities in their home jurisdictions.

3.4 After the Isle of Man announcement, Policy Council issued a Press Release which contained the following:

"The withholding tax arrangement was always considered to be transitional and the States of Guernsey has consulted with industry about a review of the position in the island.

"The international climate is changing with regards to exchange of information. We are fully aware of those developments and have had the position under review for some time.

"Guernsey's commitment to the highest international standards in transparency is constant."

3.5 In addition, there is some uncertainly as to precisely whether, or when, the transitional period will end. However, arguably a recent commitment made by Switzerland and the other jurisdictions referred to in 2.5 above, to exchange information on request in accordance with the provisions of the OECD Model Tax Information Exchange Agreement, or Article 26 of the OECD Model Tax Convention on Income and on Capital, has meant that the conditions for the transitional period to come to an end have already been met.

Furthermore, the EU Council is currently considering a draft Directive to amend the EUSD. If agreed, the amended Directive will extend the scope of the EUSD and increase the complexity of its operation. The adoption by Guernsey of the same measures as the amended Directive could make the application of a Retention Tax system increasingly complicated for paying agents based in Guernsey.

4. <u>Public Consultation</u>

4.1 In May 2010, the Fiscal and Economic Policy Group ("FEPG") issued a consultation document on a possible move to automatic exchange of information under the EUSD equivalent agreements.

4.2 The overwhelming view of the respondents was that it was inevitable that Retention Tax had a finite life. Some respondents expressed concern regarding the impact on their businesses if:

(a) a move to automatic exchange was imposed upon them with inadequate notice for them to make the appropriate changes to their computer systems; and

(b) if changes were imposed from a date which did not suit their other, non-computer, business needs and the interests of their customers/clients. For example, some, but not all, respondents gave a preference for changes to be introduced from the beginning of a calendar year.

(c) In general whilst most correspondents said they would prefer a co-ordinated movement, away from Retention Tax with Jersey, the view was also expressed that in terms of perception, internationally, it would be preferable for Guernsey to move to automatic exchange, as the only option , no later than the Isle of Man, i.e. no later than 1 July 2011.

4.3 The outcome of the consultation process was considered by the FEPG during July 2010 and, with the agreement of the Policy Council, during the course of the States Meeting in July 2010, the Chief Minister made the following statement:

"In light of the views expressed by members of industry and industry bodies, and given the States' commitment to maintaining the highest standards of tax transparency, the Fiscal and Economic Policy Group recommended to Policy Council that institutions in Guernsey should move to automatic exchange of information from January 1st 2011 and no later than July 1st 2011. This "from but by" transition period is to provide the maximum flexibility to our industry in making their necessary adjustments to their payment systems".

4.4 Notwithstanding the possible perceptions referred to at 3.3 above, it was always perceived that as the rate of Retention Tax increased, the acceptance of tax deductions would become less palatable for investors and a shift towards information exchange could be expected to follow. As noted above, with effect from 1 July 2011 the rate will increase to 35%.

4.5 To abandon Retention Tax would clearly lead to the loss of the 25% of such tax which is retained by Guernsey and which, to date, has been a not inconsiderable amount (see 2.7 above). This was, however, never expected to be a long term income stream, for the reasons that the withholding of tax from interest payments was only considered to be a transitional measure.

4.6 The present time could be considered as good as any to mitigate the loss of tax revenues from moving away from Retention Tax, because falling interest rates and the general economic climate, etc., has reduced the benefit in Guernsey in any event (from £3.7m in 2009 to £1.6m in 2010 – see 2.7 above).

5. Legislative consequences of moving to automatic exchange of information

5.1. The Foreign Tax (Retention Arrangements)(Guernsey & Alderney) Law 2004 provides the legislative framework for the Retention Tax but the "mechanics" of the scheme are governed by the Foreign Tax (Retention Arrangements) (Guernsey & Alderney) Ordinance 2005. The cessation of Retention Tax, and a move to automatic exchange, will be achievable, therefore, by amendment to the Ordinance rather than the primary legislation.

5.2. The abolition of Retention Tax should not require renegotiation of the EUSD equivalent agreements with EUMS. By virtue of Article 14 of the agreements, Guernsey can change to an automatic exchange of information before the end of the transitional period (see 2.3. – 2.5. above). In order to do so, in practice, Guernsey would have to make an election under Article 14 of the agreements to apply the automatic exchange of information provisions. This election would then disapply the articles of the agreements which regulate retention tax so that Guernsey would, thereafter, have to comply only with the automatic exchange provisions.

6. Proposals

6.1 In view of the move, by some territories, away from withholding tax (equivalent to Retention Tax in Guernsey) towards automatic exchange of information, and the representations made by respondents to the consultation process, referred to at 4 above, the Department proposes that with effect from 1 January 2011, a paying agent in Guernsey may choose, if it so wishes, to cease deducting Retention Tax from payments of interest made to residents of EUMS (and thereafter, the paying agent would be obliged only to automatically exchange information). The Department also proposes, however, that all paying agents in Guernsey must cease to deduct Retention Tax from interest payments made to residents of EUMS no later than 30 June 2011. As a consequence, from 1 July 2011, all Guernsey paying agents would automatically exchange information.

6.2 The Department believes that this "transitional" period for the abolition of Retention Tax provides the best solution for paying agents in Guernsey and their customers/clients situated in EUMS, taking into account that the abolition of Retention Tax is considered to be in the best interests of the Island, taking all matters into account, as set out in this Report.

6.3 Under the proposed transitional arrangements, set out at 6.1 above, it is possible that some paying agents in Guernsey may withhold Retention Tax from interest payments in the period 1 January 2011 – 30 June 2011 inclusive. Under the present legislation, that Retention Tax would not be paid over to the Director of Income Tax until 31 March 2012. In view of the fact that Retention Tax will cease to apply with effect from 1 July 2011, however, the Department sees no reason why Guernsey paying agents should not make payment of any such Retention Tax, to the Director of Income Tax, any later than 30 September 2011.

7. **Recommendations**

The Department recommends the States to agree:

7.1 that Guernsey paying agents should be able to cease to deduct Retention Tax from interest payments made to beneficial owners resident in EUMS from 1 January 2011, but must do so no later than 30 June 2011, after which all Guernsey paying agents must automatically exchange information in accordance with the EUSD equivalent agreements.

7.2 for any Retention Tax which is deducted by a Guernsey paying agent from interest payments made to beneficial owners resident in EUMS, in the period 1 January 2011 – 30 June 2011 inclusive, to be paid over to the Director of Income Tax no later than 30 September 2011; and

7.3 to direct the preparation of such legislation as may be necessary to give effect to the above decisions.

Yours faithfully

C N K PARKINSON
Minister