

NOTES ON THE PROPOSED ABOLITION OF THE ATTRIBUTION REGIME FOR
INDIVIDUALS (“the AR”)
for the Meeting of the Positive Action Group at the Manx Legion Hall, Douglas,
19th September, 2011

INTRODUCTION

In the good old, less complicated days, the treatment of individuals and companies residing in the Isle of Man for Manx income tax purposes was broadly comparable.

Other than the availability of personal allowances for individuals, **the general rule** was that both individuals and companies were charged to Manx income tax calculated at 20%.

Exceptionally, however, certain companies were eligible to be ‘exempt’ from the general rule of liability to Manx income tax calculated @ 20%. These companies –

- were not owned locally;
- derived their income receipts derived from sources outside the Island; and
- engaged in activities which did not include manufacturing, retailing, wholesaling or banking.

Not unnaturally, these companies were known as ‘**exempt companies**’.

‘Exempt companies’ were the EXCEPTION to the general rule.

EUROPEAN AUTHORITIES

In December, 1997, the European Union adopted a Code of Conduct for Business Taxation (‘the Code’) and, shortly afterwards, set up a working group to carry out work related to the Code (‘the Code Group’). The Code covers business taxation only and, specifically, those measures ‘which affect, or may affect, in a significant way the location of business activity.’

In 1999, the European Code Group took the view that six Manx taxation measures, including the Island’s exempt company regime, were ‘harmful’.

In May, 2002, the Isle of Man Government gave a voluntary political commitment to participate in the Code of Conduct process and undertook to abolish the ‘harmful’ measures.

ZERO/TEN

In April, 2006, the Isle of Man Government introduced its zero/ten regime of income taxation for companies. The ‘exempt company’ legislation was repealed.

Under the zero/ten regime, at first sight, all companies became ‘**nil liability companies**’ due to the application of their 0% rate of Manx income tax.

Exceptionally, however, companies which engage in banking business or derive rents from land in the Isle of Man are charged to Manx income tax calculated at the rate of 10%.

‘Nil liability companies’ (one could say ‘exempt companies’) are now THE GENERAL RULE. Banks and companies receiving Isle of Man source rental income are exceptions.

DISTRIBUTABLE PROFITS CHARGE (‘the DPC’)

At the outset in 2006, the zero/ten regime was supported by the DPC which sought to recover some of the otherwise ‘lost’ income tax receipts.

Companies with individual Manx resident shareholders were required to account for the DPC due from their individual Manx resident shareholders.

In October, 2007, the European Code Group found that the DPC was not in conformity with the principles of the Code.

The Isle of Man Government immediately announced the abolition of the DPC and the introduction of its replacement which is known as the Attribution Regime for Individuals (‘the ARI’).

ATTRIBUTION REGIME FOR INDIVIDUALS (‘the ARI’)

Like the DPC, the ARI seeks to recover some of the otherwise ‘lost’ company income tax.

Unlike the DPC, companies with individual Manx resident shareholders are NOT required to account for the DPC due from their individual Manx resident shareholders. The shareholders themselves are required to account and pay the charge to tax.

For reasons best known to the Treasury, the Minister for the Treasury and the Assessor have both described the ARI as a “*targeted anti-avoidance mechanism.*” (see Minister for the Treasury in Tynwald on 12th April, 2011, and Notice headed ‘ARI Repeal’ issued by the Assessor in March, 2011).

In fact, the ARI is the means by which the income of companies that are owned by Manx resident individuals is -

- attributed to the Manx resident individuals who own them; and
- **charged** to income tax in the hands of those individuals.

The ARI is not a ‘anti-avoidance measure’ in any conventional sense, targeted or otherwise. It is a **charge**, as was its predecessor the Distributable Profits **Charge**.

OBJECTIVE OF THE ARI

The Treasury has stated that the ARI is “*a piece of law with a particular objective behind it: to deter the use of zero-rated companies simply to wrap up investments and keep income arising from them, which would otherwise be taxable, in a tax-free ‘money box’.*”

- Notice headed ‘ARI Repeal’ issued by the Assessor in March, 2011.

In addition, “*The ARI and its predecessor, the distributable profits charge, were not put in place with the primary aim of maintaining parity between those people who earn income through companies and those who do not.*”

- Minister for the Treasury in Tynwald on 12th April, 2011.

Are we to infer that the Treasury considers that it has no real need for the tax that the ARI yields?

If the purpose of the ARI is simply to deter companies from accumulating their respective incomes, why not simply outlaw the practice?

The ARI does not prohibit companies from keeping income arising from investments held by a company, but rather it charges such income to income tax in the hands of the Manx resident shareholders in the company.

By charging the income of a company to income tax in the hands of its Manx resident shareholders, the ARI serves to bring a measure of “*parity between those people who earn income through companies and those who do not.*”

Due to the ARI, “*those people who earn income through companies*” may be said to bear Manx income tax in respect of their shares of their companies’ incomes usually reflecting a charge to tax calculated at say 10% or 11%.

In the meantime, ordinary employees “*who do not*” “*earn income through companies*” have liabilities to Manx income tax calculated at rates up to 20%.

The abolition of the ARI will further widen the gap between “*those people who earn income through companies and those who do not.*” – that is to say to between 0% and 20%.

PROPOSED ABOLITION OF THE ARI

In her Budget Speech to Tynwald on Tuesday 15th February, 2011, Anne Craine MHK, Minister for the Treasury, stated –

“In view of the likelihood that the [European] Code Group will move quickly to declare the ARI a harmful measure, the Isle of Man has decided that the ARI should be repealed.”

and

“Mr President, ... I am therefore announcing today the abolition of the attribution regime for individuals for accounting periods beginning after 6 April 2012. I will introduce appropriate legislation to give effect to this change in due course.”

On 14th September, 2011, the Isle of Man Government issued a Press Release to the effect that –

“TREASURY Minister Anne Craine has welcomed feedback from the EU Code of Conduct Group that it had agreed in principle that the Isle of Man business tax system will no longer be considered harmful if it goes ahead with its proposed withdrawal of the attribution regime for individuals (ARI).

“... The Code Group which monitors compliance with the EU Code of Conduct for Business Taxation met in Brussels yesterday (September 13, 2011).

“... The Group’s conclusion is subject to formal confirmation by ECOFIN (the EU’s Economic and Financial Affairs Council) in December.”

Presumably, the proposal for the abolition of the ARI will be placed before Tynwald by the (next) Minister for the Treasury AFTER the General Election later this month.

If so, the Treasury and Tynwald will have to move fast AFTER the General Election if the ARI is to be abolished and any consequential amendments or new charging provisions are to be approved in good time before 6th April, 2012.

CONSEQUENT UPON THE ABOLITION OF THE ARI

The ARI provides for a **charge** to Manx income tax being made on Manx resident individuals who are shareholders in companies. The **charge** is related to the amount of the income of the company that is attributable to the shareholders. Abolish the ARI and the **charge** ceases.

By definition, the introduction of the zero-ten regime in 2006 must have resulted in the loss to the Isle of Man Government of income tax that was previously charged on companies.

At least a part of the company income tax ‘lost’ due to the 0% rate was recouped through the DPC and, later, through the ARI.

Abolish the ARI and the ‘lost’ tax ceases to be recouped.

COST/BENEFIT

The absolute basic annual cost of a company in the Isle of Man is £360, being the cost of filing its annual return with the Companies' Registry.

In the absence of the ARI, for example, an individual, whether an investor or trader, who can afford to retain £5,000 in his or her company in any year will save himself or herself Manx income tax amounting to £1,000 (i.e. £5,000 @ 20%).

By extension, another £1,000 will be saved for each further £5,000 retained in a company.

Why would such an individual not acquire a company?

COMPANIES

In the ordinary course, companies in the Isle of Man are either '**public**' or '**private**'.

A '**private**' company is a company which –

- prohibits any invitation to the public to subscribe for any shares or debentures of the company; and
- includes a statement in its Memorandum that the company is a private company.

A '**public**' company is quite simply a company that is not a 'private' company.

The majority of companies in the Isle of Man that are owned by Manx resident shareholders are **private** (family owned) companies, whether **private** investment companies or **private** trading companies.

The zero/ten regime makes no distinction between **private** companies and **public** companies. With the exception of companies which carry on a banking business or derive rents from land in the Isle of Man, all companies are liable to Manx income tax calculated at the applicable rate of 0%.

Each company, whether **public** or **private**, is a legal entity that is separate and apart from its directors, shareholders and creditors.

Directors and shareholders have a variety of statutory obligations and each company, whether **public** or **private**, must not be automatically assumed to be the tame creature of its shareholder or shareholders.

PRIVATE INVESTMENT COMPANIES

Individuals who are resident and domiciled in the Isle of Man who are fortunate enough to enjoy some measure of wealth and have good reason are likely to wish to hold their assets through the medium of a private investment company. The 'good reason' may involve any number of factors including taxation, administrative convenience and good housekeeping.

The good 'taxation' reason may be UK inheritance tax. Individuals who are resident and domiciled in the Isle of Man who own property in the United Kingdom, whether in the form of land and buildings, quoted stocks and shares, bonds, etc., are likely to be liable to United Kingdom inheritance tax in respect of their property in the United Kingdom if its value exceeds the prescribed amount on their deaths.

Accordingly, each such an individual is probably well-advised to hold his or her property in the United Kingdom in a company incorporated and resident in the Isle of Man in order to enjoy the perpetual succession afforded by the company and the consequent absence of liability to UK inheritance tax.

In the ordinary course, avoidance of Manx income tax has never been an issue either for such companies or for their owners.

With the abolition of the ARI, every such person will have another good 'taxation' reason to hold their property, whether in the UK or elsewhere, in a private investment company.

For example, take a married couple who –

- are resident and domiciled in the Isle of Man;
- have formed or acquired a company incorporated and resident in the Isle of Man;
- have valued their property, whether in the form of land and buildings, quoted stocks and shares, bonds, etc., and whether the property is in the Isle of Man, UK or elsewhere, amounting to the occasional million or, indeed, to many millions of pounds;
- have advanced on loan to their company a payment amounting to, say, £100m (being the value placed on their property), for the sake of the example;
- have sold their property, whether in the form of land and buildings, quoted stocks and shares, bonds, etc., and whether the property is in the Isle of Man, UK or elsewhere, at the valuation of £100m to the company;
- have received payment of £100m from their company, being the purchase consideration for the property; and
- meet their annual living expenses out of repayments by the company of their loan.

THE COMPANY itself has NO LIABILITY to Manx income tax in respect of its income because its liability is calculated at the generally applicable rate of 0%.

THE MARRIED COUPLE who own the company have NO LIABILITY to Manx income tax (any repayment of their loan is a repayment of capital) in respect of any part of the company's income provided that they draw no part of it from the company.

PRIVATE TRADING COMPANIES

Individuals who are resident in the Isle of Man who carry on a trade or business in the Island always did have a 'good reason' to carry on their trade or business through the medium of a private trading company.

An individual's 'good reason' is likely to have included limited liability and administrative convenience. With the abolition of the ARI, there will be a particularly good 'taxation' reason – that is to say potential freedom from Manx income tax.

For example, a Manx resident individual who –

- has sufficient 'other' income and/or capital in his or her own right to meet his or her annual living expenses;
- owns a company in the Isle of Man which carries on a trade or business; and
- does not draw on any of the annual profits of the company, whether in the form of dividend or remuneration,

is well-served by the proposed regime.

THE INDIVIDUAL who owns the company has NO LIABILITY to Manx income tax in respect of any part of the company's profits, provided that he or she draws no part of them from the company.

THE COMPANY itself has NO LIABILITY to Manx income tax in respect of its profits because its liability is calculated at the generally applicable rate of 0%.

Alternatively, however, a Manx resident individual (say a young person with spouse, young family and a mortgage to support) who –

- has no other income or capital to meet his or her annual living expenses;
- owns a company in the Isle of Man through which he or she carries on a trade or business; and
- draws on the annual profits of the company to meet his or her annual living expenses,

is less well-served by the proposed regime.

THE INDIVIDUAL who owns the company HAS A LIABILITY to Manx income tax calculated at rates up to 20% in respect of his or her drawings from the company, whether in the form of dividend or remuneration.

Meanwhile, THE COMPANY itself has NO LIABILITY to Manx income tax in respect of its profits because its liability is calculated at the generally applicable rate of 0%.

Clearly, an individual who is liable to pay 20% of his or her business profits in Manx income tax will be at a disadvantage against an individual whose business profits are essentially free of tax.

DIFFERENTIAL

When Tynwald first agreed to reduce the rate of income tax for companies in 1999 from 20%, it was aware that it was forgoing income tax from the corporate body in order to attract business and employment to the Island.

- Letter from Minister for the Treasury to Members of Tynwald dated 5th August, 2011.
- Letter from Minister for the Treasury to MS dated 5th August, 2011.

This is, of course, mirrored in many jurisdictions, not least the United Kingdom where the differential between the top rate of 50% personal income tax can be compared to a corporate tax lower rate of 20%, a difference of 30%.

- Letter from Minister for the Treasury to Members of Tynwald dated 5th August, 2011.
- Letter from Minister for the Treasury to MS dated 5th August, 2011.

Yes, but the Isle of Man is not blessed with the United Kingdom equivalents of the ARI in the forms of capital gains tax and inheritance tax.

So far as I am aware, there never has been any suggestion that we in the Isle of Man adopt any such capital gains tax or any such inheritance tax.

TAX DEFERRAL?

Whenever there is a differential it can create the opportunity for income tax deferral.

- Letter from Minister for the Treasury to Members of Tynwald dated 5th August, 2011.
- Letter from Minister for the Treasury to MS dated 5th August, 2011.

The ARI is an anti-deferral measure which seeks to deter the use of companies as 'money boxes' by taxing Manx shareholders on attributed company income in certain circumstances.

- Minister for the Treasury in Tynwald on 12th April, 2011.

What *tax deferral*?

A company is a legal person. It is assessable to Manx income tax in respect of its income for a year calculated at the applicable rate, currently 0%, thereby resulting in a NIL liability. The fact that the company has a NIL liability is a matter of Tynwald's choice not the company's.

The conventional wisdom generally has it that income after tax is held to be capital. Income after tax (i.e. capital) may be invested and may produce income that is liable to tax, but the capital itself (i.e. income after tax) is not subject to any further charge to income tax.

How then can a company which –

- lawfully makes its annual return of income to the Assessor; and
- is lawfully assessed to Manx income tax calculated at the applicable rate of 0% prescribed by Tynwald,

be held to be engaged in what the Treasury Minister describes as '*tax deferral*'?

I am assuming that the expression '*tax deferral*' is thought by the Minister for the Treasury to imply a practice that is inimical to the General Revenue of the Isle of Man and, therefore, to the proper conduct of the company's income tax affairs. How can this be?

The fact that the company has a NIL liability to Manx income tax is surely not the fault of the company. The company has simply complied with the process established by the legal framework set by Tynwald. Why then should one be talking in terms of 'tax deferral' and, by implication, potentially unacceptable tax avoidance?

So far as I am aware, there is no provision either in Isle of Man company law or Isle of Man income tax law that requires a company to distribute its income, whether before or after tax, and whether in the form of dividend or otherwise. On the contrary, as a matter of practice, retained income, after tax, represents a source of capital that is frequently used to support and expand the business of a company.

PRESENT AND FUTURE COMPANIES?

..., we must consider whether our community will rapidly start to arrange their affairs so that their investments are in money box companies. While there cannot be certainty, the answer is probably no, simply because companies can be costly to set up and maintain, and they bring with them all sorts of legal obligations.

- Notice headed 'ARI Repeal' issued by the Assessor in March, 2011.

What about all the companies that are already in being?

Wealthy Manx resident individuals already have their own **private investment companies** for a whole variety of very good reasons other than avoiding Manx income tax.

In addition, many Manx resident individuals, wealthy and otherwise, already carry on their trades and businesses in the Island through their own **private trading companies** for a whole variety of very good reasons other than avoiding Manx income tax.

Surely our companies are not so costly to set up and maintain and the legal obligations that they bring with them so onerous that Manx resident individuals do not and will not 'use' them? If so, this is another matter for concern!

In any event, Isle of Man companies are readily available for anyone who wishes to buy one or to incorporate one and who is to say that they should not enjoy the full benefits of the Manx income tax law which provides companies with **NIL LIABILITIES** to Manx income tax due to the 0% rate.

PROPOSALS TO RECOVER 'LOST' TAX

The Treasury has also made at least two somewhat improbable proposals as to the ways in which the Assessor may seek to recover some of the 'lost' tax which would previously have been recovered from individual Manx resident shareholders via the ARI. They include –

First

“When ARI is repealed, there will be no immediate tax liability on the zero rate income retained by the company. However, a tax liability will arise when the money is taken out of the company. In summary, the removal of ARI may create an opportunity to defer an income tax charge but tax will have to be paid eventually.”

- Letter from Treasury Minister to Members of Tynwald dated 5th August, 2011.
- Letter from Treasury Minister to MS dated 5th August, 2011.

Why should an individual shareholder take '*the money*' (presumably income and/or accumulated income) out of the company if he or she does not need it or if he or she can find another source of funds?

In the ordinary course at the end of a company's utility, the shareholders may sell their shares to a willing buyer for a capital sum. Alternatively, the directors, presumably with the consent of the shareholders, may sell the assets of the company for a capital sum. The company may be put into liquidation, its assets realised, its creditors paid and the residue (representing 'capital' as opposed to 'income') distributed to its shareholders.

In the absence of a specific legislation to the contrary, there can surely be no further liability to Manx income tax attaching either to the company or its shareholders. Neither the company nor its shareholders have done anything other than abide by the laws enacted by Tynwald.

And yet, the Treasury Minister states that '*tax will still have to be paid eventually.*' If, therefore, it is proposed to make a charge in respect of –

- proceeds of the sales of shares in companies;
- proceeds of the sales of company assets; and
- distributions by liquidators,

it would be helpful to know about the nature and extent of the proposed charge.

See also section headed 'TAX DEFERRAL?' above.

Second

Our tax system also has a general anti-avoidance mechanism which is provided by Schedule 1 of the Income Tax Act 1980. Schedule 1 has a broad scope, and is not widely used, but we could consider how it might be of assistance once the ARI has gone.

- Notice headed 'ARI Repeal' issued by the Assessor in March, 2011.

If this is a viable proposition, what have we been doing troubling ourselves with the DPC and the ARI during the past five years?

It is difficult to see how the '*general anti-avoidance mechanism*' which is contained in Schedule 1 of the Income Tax Act 1980 will be capable of being applied to remedy the alleged shortcomings of a no longer existing charging provision (i.e. the ARI).

With the abolition of the ARI, there will be no charge to tax to be made under the ARI. Who then will be contemplating the avoidance of the ARI?

In any event, if the Assessor were to seek to invoke Schedule 1 of the Income Tax Act 1980 in any one case, he would, in effect, surely be seeking to devise his own form ARI in order to make a charge. If so, it would, in fairness, have to be explained and capable of being applied to the general body of taxpayers in the Isle of Man.

Then, in the even more unlikely event that the Assessor were to be successful on appeal, the Isle of Man would surely be back into the bind of yet another harmful taxation practice.

In any event, it would most be helpful to know the circumstances in which the Assessor '*could consider how it (i.e. Schedule 1 of the Income Tax Act 1980) might be of assistance once the ARI has gone.*'

In the meantime, the Minister for the Treasury stated in Tynwald on 12th July, 2011, "*... I understand that any mechanism which would have a similar effect to the ARI, either in statute or in practice, would not be compliant with the code.*

And, in a letter to Members of Tynwald dated 5th August, 2011, she stated unequivocally that "*there will not be a replacement for ARI.*"

- Letter from Minister for the Treasury to Members of Tynwald dated 5th August, 2011.
- Letter from Treasury Minister to MS dated 5th August, 2011.

*

At present, accountants, lawyers and other financial advisers (not to mention the general public) are largely in the dark as to the practical consequences of the abolition of the ARI next year. This cannot be a good thing. Who knows? The tax cap may even become redundant!

CONCERNS

My concerns are twofold.

On the one hand, we seem to be moving inexorably even further in the direction of a system of income tax that bears most heavily on the least well-off in our community because -

- the income of companies is already excluded from liability to Manx income tax by the application of the zero rate; and
- the abolition of the ARI will complete the process.

The Island's income tax base will be reduced to –

- employees;
- pensioners;
- unincorporated business people;
- the less well-off individual owners of trading companies;
- banking companies; and
- landlords, whether corporate or unincorporate, who derive rents from land in the Isle of Man.

After all, the Minister for the Treasury stated in Tynwald on 12th July, 2011 that -

“The Attribution Regime for Individuals, or ARI, and its predecessor, the Distributable Profit Charge, were not put in place with the primary aim of maintaining parity between people who derive income from companies and those who do not.”

On the other hand, no attempt has been or is being made to explain to our community in plain language the likely consequences of the proposed changes - notwithstanding the fact that there is a General Election at the end of this month.

INCOME TAX COMMISSION

In my paper entitled ‘A Modest Proposal for a New National Taxation Strategy for the Isle of Man’, I asked the question, ‘Does anyone remember the Income Tax Commission?’

In her letter to the Members of Tynwald dated 5th August, 2011, Anne Craine MHK, Minister for the Treasury, stated -

“I understand that the Income Tax Commission was a mainly political body, set up prior to the Ministerial system of Government by Tynwald in 1956, to advise on matters relating to taxation. In fact this is very similar to what happens now through the relevant subcommittee of the Council of Ministers.”

The great days of the Income Tax Commission were the late 1950s and early 1960s when the Island was facing equally troubled times. The population was down to 48,000 in 1961!

I was the Secretary of the Income Tax Commission in its declining years of the 1970s, but, even then, according to the best of my recollection, the Reports of the Income Tax Commission were published, thereby placing the subjects examined, the available options considered and the recommendations made in the public domain.

If indeed there is a Report by ‘the relevant subcommittee of the Council of Ministers’ relating to the proposed abolition of the ARI, is it possible that it may be published before the General Election at the end of this month?

RECOMMENDATION

I do not underestimate the difficulties facing the Treasury and the Isle of Man Government in trying to maintain government revenues while still supporting a diversified economy and continuing to meeting all other commitments.

I do not have a ready-made solution. I do not know who has - that is why I have suggested the establishment of ‘a high-powered Commission’ to examine the issues, to explore the options and to make recommendations.

Even now, with the acceptance by the European Code Group of Tynwald’s proposal to abolish the ARI, I still think that with -

- the limitation of our VAT receipts under the Customs and Excise Agreement with the United Kingdom;
- the proposed abolition of ARI; and
- the possibility that the United Kingdom will abolish National Insurance Contributions and recover the ‘lost’ contributions via income tax,

Tynwald would be well-advised to establish some mechanism to devise a new national taxation strategy for the Isle of Man.

This may not be the only way ahead, but it would surely allow for all the options to be explored and for recommendations to be made and debated in public.

Alternatively, if the work has already been done by ‘the relevant subcommittee of the Council of Ministers’, why not publish the subcommittee’s report or reports?

THE CHOICE

After the General Election, the new Chief Minister and Council of Ministers will have the unenviable choice between **EITHER** –

- battening down the hatches and pressing on with the abolition of the ARI in the New Year amid talk of promises made and reputations to be protected; **OR**
- doing what should have been done at least a year ago and establishing a mechanism to explore the options and, if appropriate, to recommend a new and/or modified national taxation strategy for the Isle of Man.

IN CONCLUSION

In conclusion, I draw your attention to the words of Jeffrey Owens of the OECD who stated in October, 2010 –

“First of all, I don’t think that any politician, at least in the foreseeable future, is going to come up with a proposal to abolish corporate income taxes. Economically it makes a lot of sense, but politically it’s a killer, so I don’t think that’s going to get onto the table. I do hope that we can start a discussion though on some of the basic assumptions that underlie the corporate income tax system.”

- Update Malcolm Couch Isle of Man Assessor of Income Tax – IOMSCA Tax Course 14 March 2011, page 97.

Would that he was right!

Mark Solly
19th September, 2011