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IMPLICATIONS OF RECENT EC TAX INITIATIVES FOR THE CHANNEL ISLANDS AND THE ISLE OF MAN

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The EC Treaty applies to all the European territories for whose external relations a Member State is responsible.[2] As far as the United Kingdom is concerned, this includes the Channel Islands and the Isle of Man, subject to the provisions of article 227(5)(c) EC inserted by article 25 of the Treaty of Accession of Denmark, Ireland and the United Kingdom. Article 227(5)(c) provides that "this Treaty shall apply to the Channel Islands and the Isle of Man only to the extent necessary to ensure the implementation of the arrangements for those islands set out in the Treaty concerning the accession of new Member States to the European Economic Community and to the European Atomic Energy Community signed on 22 January 1972". Those arrangements are set out in Protocol No 3 to the Treaty of Accession. Protocol No 3 has only six articles. Article 2 preserves the rights of Channel Islanders and Manxmen in the United Kingdom and excludes them from the provisions of the EC Treaty on free movement of persons and services. Article 6 defines the terms "Channel Islanders" and "Manxmen". Article 3 applies the European Atomic Energy Treaty to the persons or undertakings, if any, in the Channel Islands and the Isle of Man (hereinafter referred to collectively as "the Islands") who engage in activities covered by that Treaty. So far there is nothing of fiscal interest. Article 4 of Protocol No 3 requires that the Islands apply the same treatment to all natural and legal persons of the Community. This could have fiscal consequences in the unlikely event that one or more of the Islands wished to give more favourable tax treatment to residents of one Member State than residents of all the others. Article 5 is a safeguard clause which allows the Community to take protective action if "during the application of the arrangements defined in this Protocol, difficulties

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2 Article 227(3) EC.

appear on either side in relations between the Community" and the Islands. Since, as will be explained, the arrangements defined in the Protocol do not cover direct or indirect taxation (other than Community customs duties and levies) the safeguard clause cannot be invoked against the Islands in matters of domestic taxation.[3]

Article 1 of Protocol No 3 brings the Channel Islands and the Isle of Man within the customs territory of the European Community, including the rules on the free movement of goods and on competition in trade in such goods. Customs duties, agricultural levies and other duties imposed under Community commercial policy measures are levied on imports of goods into the Islands from third countries. Such duties and levies as are collected are handed over to the Community budget. They do not finance the budgets of the Islands. For customs, excise and VAT purposes, the United Kingdom and the Isle of Man are one territory.[4] For this reason, the EC directives on VAT and excise duties are applicable in the Isle of Man in the same way as they apply to the UK. The Channel Islands, on the other hand, are outside the Community for excise and VAT purposes[5] and so are free to impose their own excise and sales without reference to the Community's directives on the matter. However, since they are in the customs area of the Community, the Islands may not impose excise or sales taxes in a manner which infringes the principles of the free movement of goods and non-discrimination on the grounds of nationality.[6] The Islands are outside the Community for the purposes of any measure of the Community in relation to direct taxation, notably Council Directive 90/434/EEC on the taxation of mergers,[7] Council Directive 90/435/EEC on parent companies and subsidiaries,[8] and the Convention on the elimination of double taxation in connection

3 The commentary in the Sweet & Maxwell *Encyclopedia of EEC Law* might be read as implying the opposite: 'The British Islands are excluded from the EEC "tax union" and therefore preserve, subject to the *caveat* in Art 5, their existing special position'. (Section 20.1276A).

4 Agreement dated 1st October 1979 implemented by the Isle of Man Act 1979. See *Halsbury's Laws*, 4th edition, Volume 6, para 848.

5 Note that the Sixth VAT Directive 77/388/EEC, article 3(4) as amended by Directive 91/111/EEC (OJ 1992, L384/47) and Council Directive 92/12/EEC on excise duty, article 2(8) (OJ 1992 L/76/1) provide that transactions originating in or intended for the Isle of Man are treated as originating in or intended for the UK.

6 See Case C-47/88, *Commission v Denmark,*, [1990] ECR I-4509 and Joined Cases C-367/93 and C-377/93, *Roders,* [1995] ECR I-229.

7 OJ L225, 20.8.90, p.1.

8 OJ L225, 20.8.90, p.6.

with the adjustment of profits of associated enterprises.[9]

Since the end of 1992 programme and the failure of the Member States to agree to proposed directives on loss carry-overs,[10] loss set-offs[11] and the taxation of interest and royalty payments between parent and subsidiary companies,[12] the Commission has been relatively quiet about its proposals for new legislation in the area of direct taxation. Then, at the informal meeting of Ministers of Economic Affairs and Finance held in Verona in April 1996 the Commission initiated a discussion on harmful tax competition. These discussions continued in Mondorf-les-Bains in September 1997 and gave rise to the Commission's communication on harmful tax competition in the European Union. The communication was debated at the Ecofin Council meeting on 1st December 1997 and gave rise to two formal decisions of the Council. The first was a resolution to adopt a Code of Conduct for business taxation and the second was a formal call upon the Commission to present a proposal on the taxation and savings, i.e. of deposit interest on savings accounts.[13]

It is not proposed to examine the substance of these proposals since this has been done admirably by Professor Easson in the previous Issue of this Journal.[14] The purpose of this article is simply to examine the possible implications of these decisions for the Islands. The Code of Conduct contains the following provision:[15]

> "In particular, Member States with dependent or associated territories or which have special responsibilities or taxation prerogatives in respect of other territories commit themselves, within the framework of their constitutional arrangements, to ensuring that these principles are applied to those territories. In this connection, those Member States will take stock of the situation in the form of reports to the group referred to in paragraph H, which will assess them under the review procedure described above."

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9 OJ L225, 20.8.90, p.10.

10 OJ L225, 20.9.84, p.5 amendment in OJ C170, 9.7.95.

11 OJ C53, 28.3.91, p.30.

12 OJ C53, 28.2.91, p.26. In fact a new proposal was published this year in OJ C123, 22.4.98, p.9.

13 OJ C2, 6.1.95, p.1.

14 Alex Easson, 'Harmful Tax Competition: *The EU and OECD Responses Compared,*' ECTJ; Volume 3, 1998, Issue 1, p.1.

15 See the Decision cited, Annex 1, section M, second paragraph.

Being a measure of direct taxation, the Code of Conduct has no direct effect in the Islands. It will be demonstrated also that it does not impose any legally enforceable obligation on the UK to extend the principles of the Code to the Islands.

The Code of Conduct was not adopted in the form of a Council Regulation, Council Directive or Council Decision. It was adopted in the form of a resolution of the Member States. A resolution of the Member States is a political act. It is not one of the measures enumerated in article 189 EC which have binding force, namely a regulation, directive or decision. Thus, by adopting the Code in the form of a "Resolution of the Council and of the Representatives of the Governments of the Member States, meeting within the Council" it is clear that all concerned wished to put the Code of Conduct outside the scope of Community law, and particularly, outside the scope of article 169 EC which enables the Commission to bring Member States before the Court of Justice for failure to fulfil an obligation under the Treaty. An examination of the review mechanism instituted by the Code of Conduct supports this conclusion. The real "teeth" of the Code are to be found in the provisions which allow an aggrieved Member State to call upon another Member State to provide information on any tax measure which appears to fall within the Code[16] and to discuss and comment on a tax measure of another member State that may fall within the scope of the Code.[17] The Code provides for the setting up of a review group comprising high-level representatives from the Commission and the Member States. This review group will select the tax measures which appear to infringe the Code and proceed to assess them. The results of such assessment are to be drawn up in a report and forwarded to the Council for deliberation.[18] This mechanism shows that the Member States have not established legally enforceable prohibitions. They have set up a procedure which could lead to the Council taking a decision, *which would be legally enforceable,* with respect to the fiscal practices of one or more Member States. The same reasoning applies in relation to dependent and associated territories in respect of which the Code provides: "In this connection, those Member States will take stock of the situation in the form of reports to the [review group] which will assess them under the review procedure..."[19]

If the above conclusion were wrong, and the Code of Conduct did impose legally enforceable obligations on the UK, the question would arise as to what was the extent of those obligations. The language of section M of the Code says that

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16 *Loc, cit.*, Annex 1, Section E.

17 *Loc cit.,* Annex 1, Section F.

18 *Loc cit.,* Annex 1, Section H.

19 *Loc cit.*, Annex 1, Section M.

"Member States with dependent territories...commit themselves, *within the framework of their constitutional arrangements*, to ensuring that these principles are applied in those territories" (emphasis added). Thus, the result to which the Member States have committed themselves is qualified by the limitation that they will only act within the framework of their constitutional arrangements. (Indeed, they could hardly be expected to do otherwise). The scope of this limitation will be examined further below as are a few remarks about the Commission's proposal concerning withholding tax on savings income (deposit interest), since this has a similar provision about dependent territories.

The second decision adopted by the Member States on 1st December 1997 was a call for the Commission to present a proposal on the taxation of savings income. Pursuant to this, in May 1998 the Commission submitted to the EU Council a proposal designed to ensure that all Member States adopt a minimum rate of withholding tax of 20% on all deposit interest paid by a paying agent to a beneficial owner who is an *individual* resident in another Member State.[20] Alternatively, Member States may opt for a so-called `information system' whereby, instead of withholding tax at source, they declare the identity of the beneficiary to the tax authorities of his country. The purpose of this proposed directive is to remove economic distortions which arise from different levels of savings taxation throughout the Community. The idea is that savers' decisions should not be determined by the possibility of avoiding tax but by the intrinsic merits of the investment alternatives offered around the Community. In fact, this is the second time that the Commission has come forward with such a proposal. The first time was in 1988 when private capital movements were liberalised in the Community.[21] The concern then was that the liberalisation of capital movements would cause all private savings to move to the Member State with the lowest tax on savings income. The proposal was dropped, no doubt due in no mean part to the fact that, when Germany introduced a 10% withholding tax on deposit interest, it had to abandon it quickly in the face of massive sales of German government bonds by foreign investors.[22] The new proposal is different in that it offers Member States the possibility of establishing an information system as an alternative to imposing a withholding tax.

Annexed to the proposed directive on effective taxation of savings income is a draft decision of the Member States. Article 2 of this draft echoes the language of the

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20 COM (1998) 295.

21 The liberalisation was brought about by Directive 88/361/EEC (OJ L178, 87.88 p.5) and the proposal on withholding tax was published in ON C141, 7.6.89p.5.

22 This fact was recalled recently in *Financial Times*, 'London fights back on EU tax directive'. 3rd November 1998, p.3.

Code of Conduct about dependent and associated territories except that it is more specific as to the results to be obtained. It says:

> "Member States which have dependent or associated territories or which have special responsibilities or taxation prerogatives in respect of other territories are committed to taking appropriate measures, where appropriate within the framework of their constitutional arrangements, to ensure that provisions concerning interest payments to Community residents, equivalent to those contained in the Directive once adopted, may be applied in those territories."

Again it should be emphasised that, in its present form, this would not be a decision of the Council in the strict legislative sense, but a "Decision of the Representatives of the Governments of the Member States, meeting within the Council". Indeed, it is striking that the Commission appears to have gone out of its way not to include this commitment in the proposed directive itself, since provisions of a directive are legally binding on a Member State. Thus, in the same way as for the Code of Conduct, proceedings could not be brought under articles 169 or 170 for non-respect of the Decision.

Turning to the text of the commitment, it is in substance the same as the text of the Code of Conduct discussed above, except that the phrase "within the framework of their constitutional arrangements" is qualified by the words "where appropriate". The latter words cannot add anything since, as remarked above, it would be inappropriate for Member States to act *outside* their constitutional arrangements.

Thus the remaining issue is to determine the constitutional arrangements, if any, which would prevent the United Kingdom from purporting to impose legislation on the Islands of the kind envisaged by the Code of Conduct and the draft decision annexed to the proposed directive. The Islands are not parts of the United Kingdom.[23] Her Majesty's sovereignty over the Channel Islands derives from the fact that she is the successor to the Duchy of Normandy and the Channel Islands are the portion of the Duchy still annexed to the Crown.[24] The Isle of Man used to be held by a feudatory, but was revested in the Crown under Act of Parliament in 1765.[25] The view held in the UK appears to be that the British Parliament's right to legislate for the Channel Islands is paramount but, by convention, Parliament does

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23 See *Halsburys Laws*, 4th edition, Volume 6, para 838 and the cases there cited.

24 *Op cit.*, para 839.

25 *Op cit.*, para 848.

not tax the Islands.[26] As for the Isle of Man, the UK legislature does not, as a matter of practice, legislate in local matters, unless there has been an agreement to the contrary, as for example in matters of customs, excise and VAT.[27] The correct position would appear to be that, initially at least, the local legislature should be given the opportunity to adopt any legislation required by international obligations undertaken by the UK towards other EC Member States. In this way the UK would certainly be acting within the constitutional arrangements existing with the Islands. However, if the Islands were not prepared to adopt the necessary legislation, it seems that, in theory, the UK Parliament could pass the necessary tax legislation. Although this might be contested, the UK clearly holds the view that, in cases where the local legislature is not prepared to give effect to the UK's international obligations, the Westminster Parliament can legislate.

Nevertheless, there is a gulf between theory and practice. For the Westminster Parliament to pass tax legislation for the Islands would contradict the spirit of the principle which has given birth to constitutions elsewhere: "no taxation without representation". Moreover, without the cooperation of the authorities in the Islands, the UK would not have the administrative means of enforcing the new tax regime. Thus the only realistic solution can be through consensus, the principle behind all democratic constitutions.

An alternative course of action open, in theory, to the UK government would be to renegotiate Protocol No 3 with the other Member States in order to insert provisions obligating the Islands to comply with EC tax principles. This approach raises the same difficulties as the one just discussed. While the UK is responsible for all external relations of the Islands with other sovereign states, in practice it could not ratify an international obligation which had fiscal consequences in the Islands without being sure, in advance, that the obligation would be respected. It would in fact need to negotiate such an amendment with the agreement of the Islands, just as it did when the original Protocol No 3 was negotiated.

To conclude, there is a danger that the tax regimes in the Islands could be invoked

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26 *Op cit.*, para 839. On Parliament's right to legislate see also Relationship between the United Kingdom and the Channel Islands and the Isle of Man, Part XI of Volume I of the Report of the Royal Commission on the Constitution, 1969-1973. I am indebted to Advocate St. John Robilliard for a paper submitted to a conference organised by International Professional Conferences Ltd, in Jersey on 13th November 1998 and which contained useful extracts of the Royal Commission Report and other interesting documents relating to this question. The views expressed in the present article and any errors therein are, however, my own.

27 *Halsbury Laws*, 4th edition, Volume 6, para. 848. As explained above, this result was not imposed unilaterally by the UK but agreed with the government of the Isle of Man.

by certain other Member States as the excuse for not complying fully with the spirit of the Code of Conduct or for not agreeing to the savings taxation directive. This would be a pity for the Community. The problem of tax distortions in the Community is not limited to financial services, still less financial services in the Islands. There are many significant cases of tax distortions on the mainland which do not see the light of day but could be challenged under provisions of the EC Treaty. Rather than look for excuses outside its frontiers, the Community should at first put its tax affairs in order at home. The Code of Conduct, manifestly inspired by the work of the OECD,[28] is an important step in this direction. The OECD's Report on Harmful Tax Competition includes recommendations for the adoption of domestic measures which combat the effects of harmful tax regimes in other jurisdictions, for example, controlled foreign corporation rules, foreign investment fund rules, and restrictions on participation exemption and other systems of exempting foreign income.[29] It is suggested that these and all the other sophisticated anti-avoidance measures created by national tax administrations are the better constitutional way for the UK and other Member States to deal with any misuse of the Islands' tax regimes by individual EC taxpayers.

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28 In May 1996 the Ministers called upon the OECD to "develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998". The result was the Report, 'Harmful Tax Competition, An Emerging Global Issue' submitted to the Ministers on 27th-28th April 1998.

29 *Op cit.*, Chapter 3, Section II, p.40.