THE BRITISH ISLANDS AND THE EEC

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Introduction

The object of the following article is to examine the constitutional position of the Channel Islands and the Isle of Man ("the British Islands") within the context of the European Communities, with a view to considering the use of the Islands for the purposes of tax planning.

Origins of the Community

The Organisation of European Economic Co-operation ("OEEC") was established in 1948 to administer the Marshal Plan. The object was to administer the grant of American financial aid to Western Europe.

This was followed by France and Germany establishing the European Coal and Steel Community ("ECSC"). The objective was to establish and regulate an internal Common Market for coal and steel. The Treaty of Paris was signed in 1952 by France, Germany, Belgium, Italy, Luxembourg and the Netherlands.

The success of the ECSC demonstrated the advantages of surrendering direct control of domestic industry to achieve international control over a large market for that industry. The success of the ECSC led to the establishment of the European Atomic Energy Community ("EURATOM") and the European Economic Community ("EEC").

For some ten years the three separate Communities (ESCS, EURATOM and EEC) existed side by side. In 1967 the administration of the three separate Communities was merged into an individual legislative, judicial and executive institution, namely the European Parliament, Council of Ministers, European Court of Justice and European Commission. The three separate Communities were then referred to as the "European Communities".

In 1973 the United Kingdom, Ireland and Denmark acceded to the Communities together with Greece in 1981 and Spain and Portugal in 1986.

The EEC established by the Rome Treaty in 1958 is the most important of the three Communities. The use of the word "economic" in the title is misleading. The

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objectives of the signatories of the Treaty go far beyond economic considerations.

The preamble to the Treaty sets out the philosophy of the "Fathers of the Treaty". It refers to "social progress", "improvements of living and working conditions", reduction of the "backwardness of less favoured regions", the "development of overseas countries" and the "preservation and strengthening of peace and liberty".

Article 3 of the EEC Treaty sets out the main objectives. These include the elimination of customs duties and of quantitative restrictions on the import/export of goods between Member States and all other measures having equivalent effect; the establishment of a Common Customs Tariff; freedom of movement for persons, services and capital between Member States; the adoption of a common policy in the spheres of agriculture and transport; the institution of a system of competition to avoid distortions in the market; the application of common economic policies, the approximation or harmonisation of the laws of Member States to the extent required for the proper functioning of the Common Market; the creating of a European Social Fund to improve employment opportunities; the establishment of a European Investment Bank and the promotion of trade with overseas territories.

Treaty of Accession of the United Kingdom

The Treaty of Accession came into effect on 1st January 1973. The European Communities Act 1972 provided that EEC Law was to apply within the United Kingdom as if it formed part of domestic law. A specific protocol applies to the British Islands pursuant to the terms of the Accession Treaty.

The British Islands
Protocol 3 to the Treaty of Accession

In the late 60s in Jersey, a special committee was appointed to consider "the particular and direct consequences which might be expected to result from the Island's inclusion in, or exclusion from and future entry into the EEC". The Committee reported that full membership of the Community would create problems in the field of taxation (direct taxation, value added tax and excise duties) and in relation to agricultural and horticultural industries. A special request was made to Her Majesty's Government to negotiate special arrangements with the Community. Guernsey and the Isle of Man pursued a similar approach.

Article 227 of the EEC Treaty, as amended, states in Article 5 (c): "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 Community".

Community rules on customs matters and quantitative restrictions apply to the Channel Islands and the Isle of Man on the same conditions as to the United Kingdom. So far as freedom of movement of industrial, agricultural and horticultural products are concerned, the British Islands are treated as being members of the Community so that these items may freely be imported into or exported from the British Islands to other Member States without customs duties being imposed. In turn, the British Islands are required *vis a vis* third countries to impose customs duties on imports at levels laid down by the Council of Ministers in Brussels. There is no contribution required to be made to Brussels however.

Further Community rules necessary to allow free movement and observance of normal conditions of competition in trade in agricultural products are also applicable. The effect of such provisions insofar as the British Islands are concerned is that the provisions of Articles 30 to 34 of the EEC Treaty are to be observed. These Articles prohibit restrictions on imports and exports and all measures having *equivalent effect* (e.g., excise duties which are discriminatory in nature). Subject to the jurisprudence of the European Court in Luxembourg, these provisions therefore preclude the British Islands' Authorities from introducing or maintaining measures which prohibit the import or export of products between the British Islands and the Community, and also prohibit the use of intellectual property rights (patents, trademarks, copyright, etc.) to prevent free circulation of goods where products have been lawfully introduced onto the market in the Community.

With the exception of these provisions, subject to the comments below, none of the other provisions of Community Law in relation to industrial and agricultural products has application *within* the British Islands.

Right of Establishment and Free Movement of Persons

The rules on right of establishment and free movement of persons within the Community do not apply to persons whose parents and grandparents were born within the Islands. Conversely, by Article 4 of the Protocol, the British Islands' Authorities must apply the same treatment to all natural and legal persons of the Community. Because of the constitutional rights of persons from the United Kingdom to travel freely to the British Islands, the same treatment must therefore be afforded to all Community nationals. As a consequence, free movement of persons applies to persons emanating from within the Community but not *vice versa*.

The Single European Act

Internal tariffs and trade quotas were largely dismantled after 1957. Nevertheless, many non-tariff barriers preventing the Community from realising the goal of economic integration still persisted. These comprised border controls, government subsidies to certain industries, protected public procurement procedures and divergent regulation of financial services, transportation and product standards. It was becoming clear that a Europe of relatively small, protected national economies would be unable to compete with the United States and Japan. The European Commission published a "white paper" supervised by Lord Cockfield, the British Commissioner, setting out a programme to remove the fiscal, technical and physical barriers to the operation of a Common Market. In February 1986 the Single European Act was adopted to amend the Treaty, implementing the goals articulated in the Commission's white paper. The Act became effective in July 1987 and provided for the adoption of 300 implementing measures by 31st December 1992. (N.B. *not* 1st January 1992).

"1992" does not introduce fundamental changes into the EEC Treaty. It provides a timetable for the goals set out in the Treaty. As such, 1992 *per se* should not pose any significant problems for the British Islands.

The Maastricht Treaty

The Treaty of Maastricht signed in November 1991 has taken the Community a stage further towards economic and political integration. Under the provision of the Treaty, the member states have committed themselves to Economic and Monetary Union and the creation of a Central Bank. Although not directly affected, the likelihood of the adoption of the ECU in place of the British Pound will obviously affect the British Islands. Without their own central banks, it is almost inconceivable that the British Islands will do anything other than accept the ECU in place of the Pound.

The European Economic Area (EEA)

In October 1991, the member states of the EEC and of the EFTA reached agreement on a Treaty establishing a European Economic Area which will cover all of the European Community and EFTA. The main principle of the EEA Treaty is that as from 1st January 1993 the provisions of the EEC Treaty will operate throughout the two blocks. There will be freedom of movement of goods, persons, services and capital as between the European Communities and EFTA member states. The EFTA countries will adopt the EC rules on competition law, company law, consumer protection, education, the environment, research and development and social policies.

By definition, the tax harmonisation provisions of the EC will also apply within the EEA territory. Although the EFTA countries will not be able to vote on new EC legislation, the provisions of the three Treaties together with subordinated legislation will form the core of the EEA rules. In addition, the Commission and Council of Ministers will be required to consult the EFTA countries about proposed measures and to consult them during the course of the legislative process.

The question of whether new legislation should be applied to the whole of the EEA will be decided by a joint committee, with the right of the EFTA countries to opt out. The EEA agreement will be overseen by an independent court of EC and EFTA judges which will rule on EEA issues.

However, the European Court has ruled that the provisions of the EEA Treaty, and in particular the creation of a joint EC/EEA Court, will impinge upon its jurisdiction and the Commission is therefore obliged to find a new solution. It is unlikely that the EEA countries will readily submit the resolution of disputes to the European Court, and the proposal at present being canvassed is that of an arbitration court deciding on disputes between residents of the EEC and EFTA. The European Court is expected to accept the solution only if the arbitration awards are not binding in the Community.

The Jurisdiction of the European Court of Justice within the British Islands

In a recent judgment of the European Court of Justice in Luxembourg in *Department of Health and Social Security (Isle of Man) v Barr* (Common Market Law Reports 1991 Volume 62(7) p325) it was held that the European Court of Justice was entitled to rule on matters of law referred to it for interpretation by the Deputy High Bailiff's court under Article 177 of the EEC Treaty. However, such judgments must be restricted to the interpretation of Protocol 3. In the case in question, a restriction contained in the Control of Employment Act 1975 which restricted the taking up of employment in the Isle of Man to persons born in the Isle of Man and those linked to it by virtue of marriage or a given period of residence was referred to the European Court for a ruling on its compatibility with Protocol 3. The European Court held that the requirement on Community nationals to hold a work permit did not constitute discrimination for the purposes of Article of Protocol 3 as the provisions applied equally to all Community nationals without discrimination. This judgment constitutes a landmark in that it establishes the right of the European Court to accept references for preliminary rulings on points of law relating to Protocol 3 from within the British Islands.

EEC Tax Harmonisation Provisions

The basis for tax harmonisation provisions is to be found in Article 99 and Article 100 of the EEC Treaty. Article 99 relates to turnover taxes (VAT), excise duties and other forms of indirect taxation. Article 100 relates to direct taxation.

Lord Cockfield's white paper makes it clear that indirect taxation and the removal of fiscal barriers are regarded as essential to achieving a single market. Progress has been relatively slow as the issue of fiscal harmonisation goes to the core of national funding. The objective of the Commission is to bring VAT and other rates of indirect taxation into line throughout the Community. Although Protocol 3 makes no reference to the Community laws on tax harmonisation being imposed within the British Islands it is clear that the spin-off effect will be felt within the Islands.

Value Added Tax

With effect from 1st January, 1993 the provisions of the sixth directive on VAT will be implemented throughout the Community. VAT will no longer be charged at the point of entry when imported from another member state of the Community. So far as exporters are concerned, they will continue to be able to zero-rate their sales to the rest of the Community but only if they are supplied to a VAT registered purchaser. If the sale is to a private individual or an unregistered organisation in another Member State, the seller will no longer be allowed to zero-rate the "export". Instead, the exporter will have to charge the VAT rate prevailing in the country of export.

So far as trade between the British Islands and the Community is concerned, the effect will be marginal. Exports of products to the British Islands from the Community will continue to be zero-rated and imports into the Community from the British Islands will attract VAT on importation.

Where products are imported from third countries, that is to say from countries outside the Community, VAT will be levied at the point of entry. In all other circumstances, VAT will be due locally at the destination of the product in question. So far as products imported into the Community from the British Islands are concerned, they will be treated for VAT purposed as imports from a third country and VAT will be levied at the point of entry. As a consequence, the present border controls will continue to apply.

Excise Duties

To ensure the free movement of goods across borders within the Community, particularly goods subject to excise duties, a Community-wide authorising bonded warehouse will be introduced to which goods will be despatched duty free. Excise duty will only become payable when the goods leave the bonded warehouse "for consumption". The rate of duty will be that of the country where the bonded warehouse is located. From 1st January 1993, there will be a new type of trader in excise goods. In the United Kingdom, the trader will be known as a "Registered Excise Dealer and Shipper" or "REDS". REDS will be authorised to import and pay excise duty on goods from other Community Member States without having to submit customs entries for clearance of the goods. Excise duty will become payable at the "local" rate on receipt from another Member State.

Goods emanating from the British Islands will be treated within the Community as coming from a third country.

Abolition of Withholding Tax between EC Parent and Subsidiary Companies

With effect from 1st January 1992, withholding tax on dividend payments between qualifying EC companies is eliminated. This avoids double taxation on dividends received by EC parents from their EC subsidiaries. The directive applies where the recipient owns at least 25% of the subsidiary. Most of the common types of Member State companies qualify for this tax reduction, although transitional provisions apply in certain countries (e.g., Germany).

This provision may make the use of intermediate holding companies in the British

Islands unattractive on the basis that equal treatment on distribution of profits would be applied within the British Islands and rest of the Community.

Threat of Competition to the British Islands from EC Member States

The Netherlands with its "participation exemption" and Luxembourg with its similar provisions applicable to holding companies clearly constitute a threat to the competitive position of the British Islands from the standpoint of tax planning. The importance of the Luxembourg capital market also constitutes an added lure insofar as the UCITS directive is concerned. It will be recalled that once a fund has qualified as a UCITS under the terms and conditions of the directive in any Member State, and eventually Gibraltar, it will, subject to purely formal requirements, be freely marketable throughout the Community. Funds incorporated in the British Islands do not have similar rights, although bilateral agreements have been entered into which enable such funds to be sold in specific Member States. The convergence of taxation advantages with regulatory freedom has resulted in a number of institutions relocating from the British Islands to Continental Europe and further relocations are undoubtedly to follow.

Double Tax Treaties

Liechtenstein makes a virtue of the fact that it has entered into no significant double tax conventions. This is used as a positive feature in promoting Liechtenstein as a low tax area and in attracting business.

The position of the British Islands is somewhat different. All three of the British Islands have double tax arrangements with the United Kingdom which is the only EC state with which they have full arrangements. The absence of double tax agreements with other countries is now being reconsidered. One school of thought is that business is being lost, and will continue to be lost in the future, to countries such as Luxembourg due to the absence of such Treaties. Luxembourg, for instance, has made a virtue of increasing the number of double tax treaties which it has entered into. Jersey too is currently considering with the French Consul whether a full double taxation agreement should be entered into with France (there is currently a limited one covering transport). The question to be addressed is whether it is in the interest of the British Islands to seek double taxation arrangements with other Member States of the Community, with all the disadvantages (particularly in relation to requests for information) which these involve.

Accession of the British Islands to the European Communities

The Bailiff of Jersey, Sir Peter Crill, was recently reported as questioning whether the decision of Jersey to remain outside the European Community was in the best interest of the Island. The signature of the EEA Treaty (to which Switzerland is a signatory) may perhaps raise the issue once again of whether the British Islands are likely to improve their lot by remaining outside the Community with their present associated status or whether their future lies as full members of the Community. In general, the view of the business community is that the Islands have profited considerably from the position given to them by Protocol 3 and query whether it would be in the Islands' best interest to surrender these rights. The majority view is that the Islands would lose a great deal by surrendering their independence and are likely to do better by retaining their long-established and unique position and thus remain outside the Community. This view is likely to be given support by the recent announcement by Switzerland than an application is to be made to join the Community. This can only encourage more business to migrate to the British Islands.