Response to Consultation on a Territorial System of Taxation

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Consultation on a Territoriality
Tax Division
Department of Finance
Government Buildings
Upper Merrion Street
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Dear Sir/Madam

We welcome the opportunity to provide our views on the questions raised as part of the consultation on Ireland's potential adoption of a territorial regime of taxation. We note that this is an important issue for our clients, both domestic and international and we have highlighted in this submission, the advantages and other considerations that would arise as a result of moving to a participation and branch exemption for foreign income.

We note that the Department of Finance may invite interested stakeholders to discuss the matter further and we would be delighted to engage with the Department of Finance in respect of the next steps in the consultation should that be helpful.

If you have any questions in relation to this matter or would like to discuss any aspect in further detail, please contact Paul Fahy at pfahy@algoodbody.com or on (01) 649 2717.

Yours faithfully

A&L Goodbody LLP

Q1. What is your opinion of Ireland's corporate tax potentially moving from the current worldwide system with credit relief for foreign tax to a territorial system of double taxation relief, including participation exemption and/or branch exemption provisions?

In our view, there are compelling reasons why Ireland should move to a territorial system of taxation and provide for an exemption from Irish taxation on foreign dividend income and foreign branch income.

The move would bring Ireland in line with other jurisdictions. Currently, Ireland is the only EU Member State that does not have a form of participation exemption for foreign income.

It will soon be five years since the Coffey Report (Coffey, S. (2017), *The Review of Ireland's Corporation Tax Code*, Department of Finance) was published. We consider that the analysis and observations in that report concerning a territorial tax base generally continue to hold true. Given the numerous, and in certain instances fundamental, changes to the Irish tax code in recent years, in particular those as mandated by EU law, we believe that there is a pressing need to promptly address and implement a move to a territorial base. The difficulties, identified in the 2017 report, with Ireland's current worldwide basis with the credit system continue. We think that change is needed to maintain Ireland's competitive offering, and the current global uncertainties make maintaining competitiveness all the more important and pressing. The move internationally has been towards a territorial and exemption system backed up with appropriate measures to protect a jurisdiction's tax base (such as an effective CFC regime), which addresses certain of the difficulties identified in the Coffey Report. Ireland is at a competitive disadvantage when compared with most other jurisdictions in this regard.

We have also received consistent feedback from clients that due to the lack of the participation exemption, Ireland is at a major competitive disadvantage in comparison with both fellow Member States and other jurisdictions who operate a territorial taxation regime. That feedback has also highlighted the practical difficulties that our clients have in complying with the current credit system as outlined in Schedule 24 of the TCA. Clients have consistently highlighted the significant compliance burden associated with calculations that are required in order to comply with Schedule 24. In almost all cases, no additional Irish tax arises due to the availability of related foreign tax credits. In the context of the taxation of foreign branches, we also have clients that are suffering double taxation due to anomalies in the credit system.

A move from the current system to a territorial system of double taxation relief would, in our view, help to bolster Ireland's status as an attractive location for multi-national enterprises to establish a business or global and regional headquarters.

In terms of timing, we believe that it is imperative that the implementation of a transition to a territorial system should happen in the short term. In that context, we would argue that the relevant legislation should be included in Finance Act 2022 with the measures coming into effect for accounting period commencing on or after 1 January 2023.

Q2. What would the broad benefits be for multi-national enterprises if Ireland were to move to such a system?

We believe moving from a worldwide taxing system with credit for foreign taxes to a participation and branch exemption system of taxation would simplify administrative burdens and the complex calculations for multi-national enterprises, which are currently associated with the credit system.

Territorial exemption regimes have already received broad support internationally and their application in Ireland would ensure that the Irish corporate tax system is aligned with Ireland's main trading partners in EU Member States, UK and the US.

The Coffey Report summarised the benefits that would arise as a result of a transition to a territorial regime.

These include, for example:

(i) improving the position of domestic firms vis-à-vis the taxation of outbound foreign direct investment;
(ii) improving the attractiveness of the corporate income tax code vis-à-vis the location of holding companies; and
(iii) reducing the non-trivial compliance burden on domestic outbound investors (Coffey, 2017, p 106).

Q3. Are there any particular drawbacks or concerns for multi-national enterprises which should be considered if Ireland were to move to such a territorial system of double tax relief, including any indirect consequences or risks?

We do not believe there are any drawbacks for MNEs if Ireland were to move to a territorial system of taxation on the basis that the changes would bring Ireland in line with other jurisdictions on this issue.

One point, however, which should be given some thought, is that there should be appropriate transitional provisions in order to allow companies with losses to utilise such losses, particularly in relation to branch activities.

An important design element will be ensuring that the new system does not have complex anti-avoidance provision which would be burdensome to apply.

Q4. Are there particular examples of best practice associated with a change to territoriality in other jurisdictions which could be considered, with a view to reducing compliance burdens without increasing avoidance risks?

As noted above, many countries have already transitioned to a territorial system of taxation and some helpful insights can be gained from their experiences.

For example, the UK implemented a participation exemption system for dividends in 2009.

The UK rules are relatively broad in scope. Almost all foreign dividends received by a UK company are exempt from UK tax and a number of different types of shareholders can obtain the benefit of the exemption (there are separate exemptions for controlled companies, jointly controlled companies and portfolio holdings). In addition, there are some targeted anti-avoidance provisions intended to deny the availability of an exemption to the extent the transaction forms part of a tax avoidance scheme.

The main driver behind the introduction of the exemption for foreign dividends was part of the UK government's agenda to focus on the long-term competitiveness of the UK and to increase its attractiveness as a base for global businesses.

The principles underpinning the reforms included, for example:

- Lowering rates while maintaining the tax base
- Maintaining stability
- Being aligned with modern business practice
- Avoiding complexity
- Maintaining a level playing field for taxpayers

In addition, research on the UK shift from a worldwide to territorial system suggests that the UK did not suffer from a reduction in investment after the reform and that businesses did not shift their investment from high-tax countries or the UK to lower-tax countries but instead, the reform led to new investment abroad.

It is also helpful to consider examples of EU Member States competing with Ireland for international investment. Luxembourg and the Netherlands are two examples of jurisdictions that have an exemption regime for dividends.

The current rules in Luxembourg are that dividends and gains derived by a Luxembourg entity from a qualifying participation (broadly any entity subject to a corporate income tax rate of at least 8.5% applied on a tax base determined by the application of rules similar to those existing in Luxembourg) may be tax exempt if certain conditions in terms of shareholdings are met.

Similarly the participation exemption in the Netherlands also provides for an exemption for dividends on qualifying participations.

Q5. Taking account of the above, what in your view would be the potential impacts of moving to a participation exemption regime as set out in the Coffey Report?

We do not have anything to add to the considerations outlined above.

Q6. Are there particular considerations or design features that should be considered in reviewing the basis of the Irish corporation tax system?

In terms of the design of an exemption for foreign dividend income, there are a number of relevant considerations. In relation to the existing participation exemption for chargeable gains, there are three main qualifying conditions:

(i) the relevant investee company must be resident for tax purposes in an EU Member State or a jurisdiction that has a double tax treaty with Ireland;
(ii) the selling entity must have a minimum participation in the investee company (5% or more); and
(iii) the trading condition as outlined in section 626B must be satisfied.

It is also helpful to look at the way participation exemptions for either capital gains or dividends are designed in other jurisdictions. As outlined in our response to Q4 above, the UK participation exemption for dividends has relatively few qualifying conditions, and, instead, the availability of the exemption can, in certain cases be limited by a targeted anti-avoidance rule.

In contrast, in Luxembourg, in order to qualify for the dividend exemption, the dividend paying company must be subject to a minimum level of corporate income tax. In our view, it is important that there is alignment between the conditions relating to a participation exemption for chargeable gains and any exemption for dividend income.

However, we believe that the "residence" qualifying condition is unduly limiting. While Ireland's double tax treaty network is extensive with 76 treaties (73 of which are currently in force), there are gaps in treaty coverage. In that context, our view is that the expanded definition of "relevant territory" contained in section 21B TCA which, in addition to EU and treaty jurisdictions includes signatories to the Convention on Mutual Administrative Assistance in Tax Matters should instead be used for the participation exemptions for both chargeable gains and dividends.

Another relevant consideration is the treatment of portfolio dividends. Currently, under section 21B TCA, portfolio dividends (defined as a participation of not more than 5%) received by an entity taxable on that income under Case I are not subject to corporation tax. We think it is important that that provision is retained in its current form. If that were to be the case and any new exemption was to apply only to participations greater than 5%, that leaves open the question of the treatment of portfolio dividends taxable under Case III. Pursuant to section 21B, such dividends are deemed to paid out of trading profits (and subject to a tax charge of 12.5%). In the event that a new participation exemption for dividends is introduced, we believe that there is no justification from a policy perspective for a difference in treatment between trading income and non-trading income. Therefore, section 21B TCA should be amended so that the exemption from corporation tax set out in section 21B(4) should apply regardless of whether the recipient is taxed under Case I or Case III.

Additionally, as we think that conditions for chargeable gains and dividend income exemptions should be aligned, the trading condition that currently applies to the chargeable gains exemption should be reconsidered. We do not see a ready reason why dividend income from a trade (as that term is known under Irish tax law) should be treated in a different manner to dividend income from other activities. There are particular reasons why the Irish tax code differentiates between trading and non-trading income and we do not think that different treatment should apply to foreign sourced dividends depending on the particular business activities, which give rise to the profits out of which the dividends are paid.

An additional practical difficulty would be the application of the Irish tax law concept of trading (which is case law derived) to income from foreign sources where an analysis of trading (not from an Irish tax law perspective) will not otherwise have been carried out.

Q7. Taking account of, but not limited to, the design elements above, what in your view would be the best regime for Ireland to transition to, should a change take place? Please elaborate with consideration of the impacts, benefits and potential drawbacks both of (a) your preferred approach and (b) any approaches which you do not think would be beneficial.

As noted above, we believe that the preferable approach is to align the conditions so that they are consistent for both the existing participation exemption in respect of chargeable gains and the proposed exemption for dividends. We recommend that changes to section 626B should be introduced so that the definition of "relevant territory" is the expanded definition in section 21B and that the trading condition is removed.

We would not favour the UK formulation as a targeted anti-avoidance rule can give rise to uncertainty. In any event, we would view such a provision as being unnecessary given the scope of section 811C TCA.

Similarly, a rule which requires the dividend payer to have suffered a minimum rate of corporate income tax (calculated by reference to the tax rules of the recipient jurisdiction) on the dividend also creates complexity for taxpayers.

Q8. Please outline your view of whether Ireland's CFC rules would be adequately aligned with participation exemption and/or branch exemption regimes should these be introduced. What synergies or risks, if any, do you foresee arising?

Q9. Please identify any particular design features of these exemption regimes that could have positive or negative impacts in this context? Please elaborate.

Q10. Please identify any adaptations to Ireland's CFC rules that should be considered in conjunction with the introduction of such exemption regimes.

We propose answering Q8, Q9 and Q10 together.

In our view, Ireland's CFC regime is adequately aligned with the introduction of both a participation exemption and a branch exemption and no additional amendments would be required to that regime.

The CFC rules introduced in Ireland by the Finance Act 2018 on 19 December 2018 (with effect from 1 January 2019) are wide-ranging and consistent with ATAD. As a result, there is sufficient protection against the artificial diversion of income to low-tax jurisdictions and the introduction of a participation and/or branch exemption can operate in parallel with a robust CFC regime without creating risk. Experience in other jurisdictions where there is an ATAD compliant CFC regime and participation and/or branch exemptions support this position.

Q11. In your view, should tax relief for funding costs of investments be reviewed, with a view to restrictions, if foreign income from such investments were to be exempted? What EU law or tax treaty constraints, if any, might impede such restrictions?

The Irish tax rules relating to the deductibility of interest are restrictive when compared to other jurisdictions. The introduction of the interest limitation rule further restricts the ability to claim a deduction for interest costs.

For that reason, we do not believe that a restriction of that nature is necessary. In any event, we think that there would be real practical challenges in trying to apply such a rule – for example, it is not clear how it would be possible to link particular funding costs with individual dividend receipts.

Furthermore, we believe that any perceived imbalance in this regard would be more appropriately addressed as part of the EU Debt Equity Bias Reduction Allowance (DEBRA) initiative.

Q12. Please outline what in your view the impacts, if any, of participation exemption and/or branch exemption regimes might be on Ireland's Exit Tax rules. Do you foresee any synergies or risks in this space?

Q13. Please identify how particular design features of the exemption regimes could have positive or negative impacts in this context.

We propose answering Q12 and Q13 together.

In 2018, a new broad-based exit tax charge, as provided for in Article 5 of the Anti-Tax Avoidance Directive, replaced the existing exit tax provisions in Ireland.

The current rules should align with the introduction of a both a participation exemption and a branch exemption. While this will depend on the way in which the particular exemptions are drafted, at a high level, we do not foresee any amendments being necessary as a result of the potential implementation of the new regime.

Q14. Do you believe that a review and simplification of Schedule 24 could be feasible and sufficient, instead of changing to participation exemption and/or branch exemption regimes? How might this simplification be achieved?

Q15. What in your view are the relevant considerations in terms of any simplification of Schedule 24?

We propose answering Q14 and Q15 together.

In our view, the introduction of exemptions is a more preferable approach than seeking to amend Schedule 24. In addition, exemptions better aligns Ireland's tax system with what is now the norm in almost all other jurisdictions.

That being said, changes are nonetheless required to Schedule 24 to deal with a scenario where, for example, a dividend does not qualify for the participation exemption. The operation of Schedule 24 in its current form is too complex as it requires both the identification of the precise source of income out of which a dividend is paid and the amount of tax suffered on that income.

We believe that a mechanism similar to the provisions outlined in Paragraph 9I of Schedule 24 which allow for an additional foreign tax credit for certain dividend receipts where the credit is calculated by reference to the nominal rate of corporation tax in the jurisdiction of the dividend paying company should form the basis for the calculation of foreign tax credits.

Q16. In the event of Ireland moving to participation exemption and/or branch exemption regimes, what simplifications, if any, could be considered for the remaining credit system of double taxation relief - including in respect of foreign-source interest and royalty income and out-of-scope dividend, branch income and capital gains?

We have the following observations with regards to the tax treatment of royalty income.

While we are not advocating that a receipt of royalty income ought to get the benefit of an exemption from Irish tax, the current foreign tax credit regime is unduly restrictive and does not provide for adequate relief from foreign withholding taxes imposed on the payment of royalties to an Irish resident recipient.

In particular there should be an ability offset unused credits against other income of the trade. In addition, there should be an ability to pool excess tax credits so that they can be used in later accounting periods.

Q17. Please outline how territorial participation exemption and/or branch exemption regimes could impact on Ireland's Anti-Hybrid rules. Do you foresee any synergies or risks arising from the change?

Q18. Please identify any specific design features of exemption regimes that could have positive or negative impacts in this context? Please elaborate.

Q19. Please identify any adaptations to Ireland's Anti-Hybrid rules that should be considered in conjunction with a transition to such exemption regimes.

We propose answering Q17, Q18 and Q19 together.

The Finance Act 2019 introduced broad-ranging anti-hybrid provisions to Irish tax legislation, which apply in respect of all deductible payments made or arising on or after 1 January 2020.

The primary effect of the anti-hybrid provisions is that, where they apply, a tax deduction can be denied in respect of payments made by Irish-resident companies, or Irish branches, that give rise to a hybrid mismatch.

We recognise that when the rules were introduced, they were drafted with a worldwide taxation system in mind. Depending on the way in which any new participation exemption or branch exemption is designed, it may be necessary to make conforming changes to the anti-hybrid provisions. At a high level however, based on the experience in other jurisdictions, it is possible to have the contemplated exemptions sit alongside anti-hybrid rules.

Q20. Do you foresee potential impacts, arising from moving to participation exemption and/or branch exemption regimes, for the way in which the two pillar solution is implemented in Irish tax law? Are there any potential synergies or risks with the implementation of the two-pillar solution and such exemption regimes?

The two-pillar solution will be implemented in 2023 following an ambitious timeframe. Consultation processes are ongoing or are yet to be commenced and there is not yet detail on certain key aspects such as the Implementation Framework. Potential challenges that may arise between the two-pillar solution and the move to a territorial system may be identified as matters progress.

However, despite any potential concerns that may arise, we do not readily see why a change to a territorial base system should affect the way in which the two pillar solution shall be implemented into Irish tax law. Such implementation should be on foot of the relevant EU directives, the proposed drafts of which closely follow the drafting of the OECD model rules.

That being the case, we would expect "qualifying income" for the purposes of Pillar 2 effective tax rate calculations to largely exclude dividends and gains on equity (except with respect to portfolio shareholdings of <10%). Similarly, net income or losses of a permanent establishment would not be taken into account in calculating the qualifying income of the head office for effective tax rate calculation purposes. As a result, Pillar 2 would appear to assume that most jurisdictions operate a form of territorial system for dividends, gains on equity and branch profits.

In particular, given the Minister for Finance's comments in October last concerning the particular assurances received from the EU regarding the EU not seeking to "gold plate" the OECD rules, we would not expect, nor do we see any good reason for, Irish domestic law implementing the OECD two-pillar solution to deviate in any material manner from the relevant EU directive measures due to any change to a territorial base system.

Q21. Do you foresee potential impacts, arising from moving to participation exemption and/or branch exemption regimes, for Ireland's tax treaties?

Q22. Should the renegotiation of Ireland's tax treaties, as respects the Elimination of Double Taxation article, be considered in the event of the enactment of participation exemption and/or branch exemption regimes? Would this be necessary? If so, how might it be feasible to accomplish this in a targeted and efficient manner?

Q23. Would any amendment of Ireland's worldwide tax system to allow for exemption of foreign dividends, gains or branch income necessitate a review of specific tax treaties in Ireland's network, where previously Ireland's worldwide charge would have ensured taxation of such dividends, gains or branch income? Alternatively, could such taxation be ensured by limiting the scope of any exemptions enacted in domestic law?

We propose answering Q21, Q22 and Q23 together.

The renegotiation of individual tax treaties would be a very burdensome exercise.

In our view, the better alternative would be to provide that the application of either the participation exemption or branch exemption would be at the election a taxpayer.

In that way, in the event that a treaty partner was to deny treaty benefits as the result of the availability of an exemption from tax, a taxpayer could elect to have the relevant income subject to tax in the normal manner (with the availability of foreign tax credits), if that outcome was more favourable than a denial of treaty benefits. This approach is consistent with the applicable regime in the UK.

Q24. Do you foresee impacts in relation to the matters identified above or any other matters related to transitional arrangements?

We do not have anything to add to the considerations outlined above.

Q25. In your view, what other relevant considerations should be taken into account? You may wish to consider this question in the context of the recent OECD Inclusive Framework Two-Pillar agreement.

We do not have anything to add to the considerations outlined above.


Thank you
A&L Goodbody