Solicitors
70 Sir John Rogerson's Quay
Dublin 2 Ireland
D02 R296

T +353 1 232 2000
F +353 1 232 3333
W www.matheson.com
DX 2 Dublin

Matheson

Review of the Corporation Tax Code - Public Consultation
Tax division
Department of Finance
Government Buildings
Upper Merrion Street
Dublin 2
**By Email ctreview@finance.gov.ie**

| Our Ref | Your Ref | 30 January 2018 |
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| JR/COM/OL | | |

Dear Sir or Madam

**Review of the Corporation Tax Code | Public Consultation**

Matheson welcomes the opportunity to comment on the Consultation Paper issued on the Review of the Irish Corporation Tax Code (the "**Consultation**"). We have focussed our comments on the changes that must be implemented by 1 January 2019 under the Anti-Tax Avoidance Directive ("**ATAD**") and in particular on the introduction of controlled foreign company ("**CFC**") rules. We have provided some limited comments on other aspects of the Consultation.

The provision of limited comments should not be taken as implying that those aspects of the Consultation are less important, rather we consider that the immediate focus should be on the detail of the changes that are imminently required, with the changes that are due at later dates being the subject of detailed consultation in the second half of this year and into 2019.

## 1 Implementing a general anti-abuse rule under ATAD

Ireland's existing anti-avoidance rule under section 811C of the Taxes Consolidation Act 1997 ("**TCA**") caters as a general anti-avoidance rule. The breadth of section 811C TCA should not require extension to implement the general anti-abuse rule included in the ATAD ("**EU GAAR**").

## 2 Implementing controlled foreign company rules under ATAD

### 2.1 Ireland's CFC policy should reflect Ireland's broader international tax strategy

The design of the Irish CFC regime should reflect Ireland's existing international tax strategy. Each of the EU Member States will develop rules in line with their own policy priorities as recognised by paragraph 12 of the Preamble to the ATAD.

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Ireland is one of the most open economies in the world and has benefited greatly from globalisation. An important element of Ireland's economic strategy is attracting foreign direct investment – a strategy that has proved extremely successful. Ireland's corporate tax policy has always been a key component of its strategy in attracting and maintaining foreign direct investment. Ireland's CFC policy should be consistent with its broader international tax strategy.

In this respect, from a policy perspective it would be more appropriate for Ireland, in designing its CFC regime, to adopt the approach that treats income diverted from Ireland as CFC income (as outlined in Article 7(2)(b) of the ATAD ("**Option B**")).

The alternative approach to defining CFC income (in Article 7(2)(a) of the ATAD ("**Option A**")) could result in income that has no connection with Ireland falling within the Irish CFC charge. That approach is more suitable for capital exporting nations and is inconsistent with Ireland's international tax strategy. If Ireland is to implement a CFC regime that is coherent with existing tax policy, the definition that concentrates on income diverted from Ireland is the better option.

Further, Option B is consistent with Ireland's general tax policy in developing anti-abuse rules where the preference to date has been not to adopt formulaic legislation (for example, our 'CFC' type rules aimed at individuals diverting profits from Ireland, our approach to our general anti-avoidance provision and our adoption of the principal purpose test rather than limitation of benefits provision in the Multi-lateral instrument).

### 2.2 Advantages of adopting approach in Option B

In addition to being consistent with existing Irish tax policy, the definition of CFC income included in Option B has advantages over the definition included in Option A.

2.2.1 *Option B is targeted at the erosion of the Irish tax base*

Concentrating the definition of CFC income on income that is diverted from Ireland is a proportionate response to the profit shifting risks that exist in an Irish context.

2.2.2 *Option B is targeted at CFC income that is generated from significant people functions based in Ireland*

This nexus should, as a general rule, make CFC income much easier for Irish taxpayers to identify and should result in a detailed CFC analysis being required for fewer foreign subsidiaries. Given the limited lead-time available to Irish taxpayers to manage their CFC positions, this option from a compliance perspective is preferred.

2.2.3 *Option B is a more robust option from a tax policy perspective than Option A*

The income that may be treated as CFC income under Option A is limited to the categories specifically identified and if one third or less of the income of a foreign subsidiary falls within the categories specified, no CFC charge arises. This potentially creates opportunities to mitigate against CFC charges arising. Equivalent categorisation and thresholds do not exist under Option B.

2.2.4 *Under Option B, all income earned by foreign subsidiaries is excluded unless it has an Irish nexus*

The starting point under Option A is that almost all income of foreign subsidiaries is included as CFC income unless it can be excluded under the rules. This starting point under Option A is difficult to reconcile with Ireland's pre-existing policy that regarded CFC rules as unnecessary.

2.2.5 *Consistency with our trade partners*

The UK originally had a CFC regime that operated in a similar way to Option A. However, more recently they have opted to introduce a CFC regime based on the approach in Option B following on from a five year consultation process. Ireland should take the benefit of the UK experience given that it has a similar tax system in a number of respects. Separately, we should be cognisant of Brexit related business activities that may need to migrate from the UK, by introducing a CFC regime that is not dissimilar to the UK. This would be helpful to businesses that are familiar with the UK rules and would have already carried out a detailed analysis in respect of those rules.

2.3 **Disadvantages of adopting approach in Option A**

At first blush it is argued that the approach in Option A provides more certainty due to the application of formulaic rules, however, this approach is not consistent with Irish tax policy and has significant disadvantages when considered in detail.

2.3.1 *Significantly greater tax compliance burden under Option A*

Adopting Option A will impose a significantly greater compliance burden on Irish companies with subsidiaries in receipt of any of the categories of income identified in paragraph (a) of Article 7(2) of the ATAD. The categories of income identified in paragraph (a) are extremely wide-ranging and in reality the provision only excludes third party sales and services income not generated from intellectual property.

Once a subsidiary of any Irish company earns any income other than third party sales or services income not generated from intellectual property, a complete CFC analysis will be required to determine (a) whether that income represents less than one third of its earnings and if not, (b) whether the company carries on substantive economic activity.

The substantive economic activity test is fact specific and will require detailed analysis. In many cases it may be practically difficult to obtain such detailed information in a timely manner, including the fact that the Irish company may have limited powers as a direct or indirect shareholder to obtain such information on day to day activities. That analysis coupled with the effective tax rate ("**ETR**") test will result in an extremely high compliance burden for Irish taxpayers with foreign subsidiaries. The lead-time that is now available to Irish taxpayers to undertake the CFC analysis is extremely limited and it would be unreasonable to expect taxpayers to be ready to comply with such administratively burdensome rules from 1 January 2019.

Whereas, under Option B, the Irish company is required to focus on its own activities and thus, has the relevant information readily available to determine the nexus between Irish activities and the CFC's income. Certain companies may have concerns in relation to the application of the test in Option B where they have significant headquarter operations in Ireland. However,

those concerns should be capable of being dealt with by clear guidance from the Revenue Commissioners, which will be required under both options.

As an aside to the comments above, although the substantive economic activity carve-out imposes a significant compliance burden on taxpayers seeking to rely on it, should Ireland opt to define CFC income in line with Option A, it is imperative that a 'significant economic activity' carve-out is available for all foreign subsidiaries regardless of whether they are located within or outside the EEA. A regime that treats broad categories of income as CFC income without any carve-out for cases where the foreign subsidiary undertakes meaningful economic activity would be extremely difficult to justify.

2.3.2 *Income that has no Irish nexus will be regarded as Irish CFC income under Option A*

As a broader point, the categories of income identified as CFC income under Option A are overly inclusive and will result in income that has no Irish nexus being regarded as CFC income. Unlike the test outlined in Option B, foreign income can be regarded as CFC income under the test in Option A regardless of whether or not that income has any Irish nexus.

Moving from the existing Irish tax system, which imposes no CFC charges on companies, to one that seeks to include income that has no connection with Ireland as CFC income, would mark a significant extra-territorial extension of the Irish tax base and would not be in line with Ireland's international tax strategy.

2.3.3 *Option A disproportionately impacts the financial services sector*

Adopting the approach in Option A will disproportionately affect taxpayers operating in the financial services sector. Half of the categories of income that are listed under Option A are categories of income typically earned by those operating in the financial services sector. Adopting the CFC income test in Option A will therefore be extremely burdensome for taxpayers operating in the financial services sector who will have to either perform the ETR test or undertake the fact-based substantive economic activity test to confirm that no CFC charge arises.

Although a carve-out has been included for EU regulated financial undertakings that earn less than one third of their income from related parties, this carve-out has a cliff-edge effect and will result in all income (whether earned from related or unrelated parties) being regarded as CFC income once the one third threshold is breached.

Many of the submissions on the OECD's Base Erosion and Profit Shifting ("**BEPS**") Action 3 discussion draft on CFC rules highlight the particular uncertainty that arises when applying CFC rules to the financial services sector. The difficulties inherent in applying CFC rules to the financial services sector are also reflected in the US Sub-part F regime, which for many years entirely excluded banking activities.

Any decision to opt for the CFC income test outlined in Option A should therefore be considered carefully. In particular, this arises at a time when the financial services sector is already struggling with the implications of Brexit on their business. Having a regime that is similar to the approach in the UK CFC regime would be greatly welcomed by the financial services sector as they focus on their Brexit planning.

2.4 **Significant additional compliance burden for taxpayers**

The application of CFC rules to Irish taxpayers for the first time will impose a significant additional compliance burden, regardless of whether taxpayers actually incur CFC charges.

Much of the work in applying CFC rules is often an exercise in confirming that no additional charges apply. Many taxpayers to whom the rules will apply will have hundreds of foreign subsidiaries. The compliance burden should not be underestimated. Accordingly, in implementing the ATAD, the Department of Finance should be mindful of the additional burden that will be imposed on taxpayers and should seek to mitigate that burden as much as possible without compromising the rationale underpinning the new regime.

2.4.1 *A whitelist would partially relieve the compliance burden*

The publication of a white list (as suggested in paragraph 12 of the Preamble to the ATAD) is something that would be widely welcomed by taxpayers. A white list would limit the compliance associated with the so-called 'ETR test' in Article 7(1)(b).

The ETR test applies regardless of which formulation of CFC rules is adopted under the ATAD. It requires taxpayers to compare the tax paid by the foreign company and the tax that would be paid if that company was Irish resident. Applying the ETR test requires a detailed computation, a requirement that is extremely administratively burdensome. This requirement should be alleviated where doing so does not undermine the purpose of the regime.

One practical way of alleviating the compliance burden associated with the ETR test is to adopt a white list (as contemplated in the Preamble to ATAD and the final report issued under Action 3 of the OECD's BEPS project). Many other CFC regimes have similar types of white lists as highlighted in the final report issued under BEPS Action 3.

2.4.2 *ETR tests should not be required for every foreign subsidiary*

Given the significant compliance burden associated with the ETR test, the Irish rules should not impose a requirement to perform the ETR test in respect of every foreign subsidiary. It should be possible for a taxpayer to satisfy themselves that a CFC charge does not arise (for whatever reason in accordance with the legislation) without any requirement to confirm whether the subsidiary is a CFC when applying the ETR test. Therefore, there should not be an administrative reporting requirement in respect of the ETR test.

2.4.3 *A 'gateway test' should be included in the design of the rules*

In designing their rules, the UK adopted a practical so-called 'gateway test'. The gateway test limits the requirement to undertake a detailed CFC analysis in cases where certain conditions are met that demonstrate that the income of the foreign subsidiary is not in the nature of income that has been artificially diverted from the UK. If any of the four gateway test conditions are met, the foreign subsidiary will not be regarded as earning CFC income.

The UK gateway test reflects the fundamental policy decisions made in the design of the UK CFC rules:

(a) in general terms, if an arrangement under which a foreign subsidiary holds assets or bears risks is not tax motivated, then the income of the foreign subsidiary should not

be CFC income. A similar gateway condition is expressly contemplated in Article 7(2)(b) of the ATAD;

(b) if a foreign subsidiary has no UK managed assets and bears no UK managed risks, then the income of the foreign subsidiary should not be regarded as CFC income. This gateway condition effectively examines whether the foreign subsidiary relies on activity in the UK in earning its income. One important point to emphasise under this analysis is that the activity in the UK that is examined is activity that relates specifically to the foreign subsidiary. To the extent the UK parent sets parameters according to which the foreign subsidiary operates or determines the global strategy of the group, the foreign subsidiary should not be regarded as having UK managed assets or risks provided active decision making with respect to the assets and risks of the foreign subsidiary are undertaken outside the UK;

(c) in cases where a foreign subsidiary does have UK managed assets or risks, it will not breach the gateway test if it has the capability to ensure that its business would be commercially effective if those assets and risks were no longer managed from the UK. In many respects, this gateway condition (combined with the gateway condition at (b)) operates as a substance test and reflects the UK policy that foreign subsidiaries that have real substance should not be regarded as CFCs. This approach is aligned with the outcomes of BEPS and Ireland's international tax strategy. In addition, it reflects the approach contemplated in paragraph 12 of the Preamble to the ATAD which notes that countries may limit "*CFC rules to income which has been artificially diverted to the subsidiary"* and can "*precisely target situations where most of the decision-making functions which generated diverted income at the level of the controlled subsidiary are carried out in the Member State of the taxpayer."*

2.4.4 *Transitional arrangements*

Ireland should consider including a provision that provides an exemption from the CFC rules for subsidiaries acquired from third parties during the course of the relevant taxable period. This would allow the taxpayer time to evaluate the application of the CFC rules to the acquired subsidiaries. Typically in such scenarios it can be difficult to obtain the relevant information from the acquired group and / or there is a post-acquisition integration that will affect the subsidiaries. There is nothing in ATAD to prohibit the inclusion of such a provision.

2.5 **Administrative burden on the Revenue Commissioners equivalent under both options**

From the perspective of the Revenue Commissioners, the task of administering the CFC rules should be equivalent under both Option A and Option B. Regardless of which option is selected, the onus will be on the taxpayer to correctly self-assess any CFC charges arising. Similarly, on audit, regardless of which option applies, the Revenue Commissioners will have to satisfy itself that the income of foreign subsidiaries that is not reported as CFC income is accurately excluded. Under both options this will require an analysis of the facts and circumstances, and both options should be amenable to AI audit tools.

2.6 **Increased risk of double taxation**

There is a risk of double taxation in cases where a CFC is held indirectly by Ireland through another EU holding company. While the ATAD permits a tax credit to be taken for any local taxes incurred in the jurisdiction of the CFC, it is silent on the availability of credit for CFC

charges imposed in other jurisdictions. Which jurisdiction should have taxing rights when more than one country imposes a CFC charge on the same income? As acknowledged in the BEPS Report on Action 3 CFC rules should be designed *"to ensure that they do not lead to double taxation"* and thus, Ireland should include measures to clearly eliminate any such risk of double taxation arising.

### 2.7 Making the most of the limited lead-time available

As highlighted above, the lead-time for the introduction of CFC rules is extremely short. In contrast, when recently updating their CFC rules, the UK spent over five years consulting intensively with the relevant stakeholders. Although limited time is now available, it is important that stakeholders be afforded an opportunity to review and comment on draft legislation. This should result in fewer unintended consequences and in a regime that is workable, something that is in everyone's interests.

In addition to consulting on draft legislation, taxpayers would welcome draft guidance being published by the Revenue Commissioners as early on in the process as possible (and ideally at the same time draft legislation is made available) for comment. Taxpayers and advisers will be able to provide practical comments on draft guidance and that should result in more useful guidance.

## 3 Implementing an exit tax under ATAD

The key considerations in implementing the exit tax under ATAD are (a) the rate and (b) the base.

### 3.1 The exit tax rate

The ATAD leaves the determination of rate squarely within the competence of Member States. Ireland's existing capital gains tax rate is one of the highest rates among our OECD peers. In 2015, Ireland's 33% rate was identified by the OECD as the third highest amongst OECD countries. At that time the OECD weighted average rate was 23.2%.

In broader terms, Ireland should consider the impact the high rate has on Ireland's attractiveness as a knowledge based entrepreneurial economy, particularly for start-up and scaling companies who may be looking at all potential exit strategies in choosing a jurisdiction in which to scale.

Although not central to decisions made to locate in Ireland, those looking to invest in Ireland for the first time will consider the consequences arising on exit, including the tax consequences. A high exit tax is more likely to deter new projects establishing in Ireland.

It seems reasonable that taxpayers who use assets for the purpose of a trade carried on in Ireland should not suffer a rate that is higher than the rate applicable to trading profits. Accordingly, in our view a 12.5% rate would be appropriate.

### 3.2 The exit tax base

As important as the proposed tax rate, is the proposed tax base. The ATAD requires tax to be paid on the difference between the market value of the assets on the date of exit and 'their value for tax purposes'. The ATAD gives no indication of what the value of an asset is for tax

purposes. Accordingly this is something that must be determined by Ireland on implementation.

When Ireland first introduced capital gains tax, taxpayers were permitted to re-base their assets as of that date for the purposes of capital gains tax. Similarly, taxpayers that may not have been within the charge to exit charge on migration from Ireland will come within its scope. Accordingly, it seems appropriate to permit taxpayers that pre-1 January 2020 may not have been subject to an Irish exit tax to 're-base' their assets for the purposes of the exit tax with effect from 1 January 2020.

In advance of introducing the exit tax, it would also be expedient to expressly legislate for how the base cost of an asset should be determined if it was owned by a company on its migration to Ireland. We note that in cases where companies migrate from other EU jurisdictions, the base cost will be determined by reference to the market value of the asset on the date of migration and suggest that this should be extended to all migrations into Ireland. To set the base at an amount that is lower than the market value of the asset on migration to Ireland would include gains that were accrued outside of Ireland within the Irish tax base. This would be contrary to the comity of nations and principle against extra-territorial exercise of taxing rights.

## 4 Implementing the anti-hybrid rules under the amendment to the ATAD ("ATAD 2")

The first elements of the anti-hybrid rules are due to be implemented by 1 January 2020. The rules are complex and the interplay of the rules with tax rules of foreign jurisdictions will further complicate the administration of the regime. It is critical that the Irish legislation to implement the anti-hybrid rules is carefully and clearly drafted. It should go without saying that the provisions that have been included in the ATAD 2 are not suitable for direct transposition into domestic law.

Ireland has almost two years to draft anti-hybrid rules that operate as intended under the legislation. Time should be taken to draft and consult on Ireland's anti-hybrid legislation (it is likely that more than one round of consultation will be required) to limit unintended consequences. We would be pleased to participate in any such process.

## 5 Implementing the BEPS transfer pricing changes

The incorporation of the 2017 OECD Transfer Pricing Guidelines (the "**2017 Guidelines**") into Irish law is something that taxpayers will require adequate lead-time to prepare for. The changes agreed under BEPS, particularly with respect to allocation of risk and the pricing of intangibles amount to material changes to the approach outlined in the 2010 OECD Transfer Pricing Guidelines.

Many companies are already in the process of reviewing their transfer pricing policies but need to be given time to understand how the 2017 Guidelines will apply to current structures. This may result in companies deciding to implement restructurings, which given the focus in the 2017 Guidelines may include moving people and operations. Companies typically require a long lead in time to facilitate such restructurings to ensure that internal operating systems are changed, employees have time to make arrangements for moving to a new jurisdiction etc. Therefore, a clear indication of the proposed timing to incorporate the revised guidelines should be made available to taxpayers as soon as practicable.

Further, it should be clear in respect of implementation that the 2017 Guidelines will only apply prospectively and cannot be relied on by auditors in respect of period prior to the 2017 Guidelines being adopted in Irish law.

The 2017 Guidelines will be open to interpretation by both Revenue and foreign tax authorities and it will likely be some time before there is any concensus reached on how they will be applied in practice. It would be helpful in this context if Revenue considered publishing guidance on their views and interpretation of the application of the 2017 Guidelines.

## 6 Other considerations regarding Ireland's domestic transfer pricing rules

### 6.1 Applying transfer pricing to agreements entered into before 1 July 2010

In principle, we do not disagree with applying transfer pricing rules to pre-July 2010 agreements but consider that if Ireland adopts that approach, taxpayers should be given sufficient advance notice of when the grandfathering will cease to apply.

### 6.2 Extending the transfer pricing rules to SMEs

Any proposal to extend the transfer pricing rules to SMEs should be carefully considered under a cost / benefit analysis both for SMEs and for the Exchequer. The administrative burden and cost to SMEs of complying with transfer pricing rules should not be underestimated.

If transfer pricing rules were extended to SMEs, the Revenue Commissioners would equally be under an obligation to monitor and audit compliance with those rules. This would impose a significant strain on resources. In many cases, given the size of the companies under inspection, the revenue raised on audits may not justify the costs incurred and the resources redirected from higher value transfer pricing matters.

SMEs tend to have fewer related party transactions and therefore, the cost-benefit analysis of imposing additional compliance burden on SMEs should be a strong influencing factor in deciding whether to extend transfer pricing rules to SMEs.

### 6.3 Extending transfer pricing rules to non-trading income

We understand from the Review of Ireland's Corporation Tax Code that the primary driver for suggesting an extension of Ireland's transfer pricing rules to non-trading transactions is the level of interest free loans that have been made by Irish companies to foreign counterparties. We note that this was identified as an 'active indicator' in a European Commission commissioned study. From a policy perspective we accept that it is important from a reputational perspective that Ireland addresses the perceived problem. However, we consider that targeted rules should be introduced to address these transactions, rather than applying a broad-brush approach.

The fact that Ireland's tax system is a dual-rate regime was a consideration when the Irish transfer pricing rules were first introduced. It was considered unreasonable to apply transfer pricing adjustments to transactions entered into between a trading company that was taxed at 12.5% and a non-trading company taxed at 25% as that would result in a mismatch in domestic tax treatment. This remains the case and remains a sound policy reason for not extending transfer pricing to non-trading transactions. Therefore, should a decision be made

to extend the transfer pricing rules to non-trading transactions, this should be taken in tandem with consideration of changing to a single rate system to avoid such disparities arising.

We believe that the existing rules in relation to the taxation of capital gains should be sufficient and do not require to be brought within a transfer pricing type arrangement.

## 7 Moving to a territorial regime and reviewing Schedule 24, TCA

### 7.1 Moving to a territorial regime

We are strongly supportive of moving to a territorial regime for a number of reasons:

- Ireland is now an outlier as one of the few OECD countries that has retained a worldwide tax regime, now that the US has moved to a broadly territorial regime. In terms of our obligations at EU level, it is clear that many of the EU law changes that have recently been agreed (including the ATAD) are designed primarily with a territorial regime in mind. Implementing the agreed EU law measures is more cumbersome for countries like Ireland that operate a worldwide tax regime.
- Given the extensive credits available under Schedule 24 of the TCA, a move to a territorial regime is likely to be revenue neutral.
- Schedule 24 is one of the most complex parts of the Irish tax legislation and this makes it expensive to administer for taxpayers and for the Revenue Commissioners.
- Those operating in the financial services sector generally set up their foreign businesses as branches rather than subsidiaries for regulatory reasons. In light of Brexit, some financial services businesses that are currently operating in the UK are considering new locations for their operations. For many of those businesses, operating in a jurisdiction that offers a territorial regime for branches and subsidiaries similar to the UK is preferable for simplicity.

### 7.2 Simplification of Schedule 24

On the expectation that any territorial regime that would be adopted by Ireland would be limited to dividends and branch profits that arise from EU, treaty partner and other taxing jurisdictions, the simplification of Schedule 24 will be required in any event. The evolution of Schedule 24 reflects a series of EU cases and as a result the schedule is extremely cumbersome and can be difficult to apply.

We suggest that Schedule 24 is entirely re-written to reflect the policy rationale underpinning the existing provisions. Full credit should continue to be available for all foreign taxes directly and indirectly imposed on amounts that are subsequently taxed in Ireland. Stand-alone provisions may be required to deal with the treatment of amounts received from EU Member States (to reflect the evolution of EU law). As far as possible, the Schedule should be re-drafted in a coherent and consistent way.

## 8 Interest Limitation Rules

Article 4 of the ATAD will introduce interest limitation rules for the first time in Ireland. The legislation implementing these rules and the scope of it will be very important for Ireland's financial services industries (including aircraft leasing, securitisation and treasury

activities). As we understand that the interest limitation rules will not become effective until 1 January 2024, we have not considered them in detail at this point. Having said this, it is critical that a similar public consultation is launched before relevant legislation is proposed, so that the impact interest limitation on Ireland's financial services industry can be given thoughtful consideration.

Should you wish to discuss any of the comments raised in this letter, please do not hesitate to contact us.

Yours faithfully

*Sent by email, bears no signature*

**MATHESON**