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# *Consultation on the Review of Ireland's Corporate Tax Code*

Consultation Questions 2 & 10

*Strictly Private and Confidential*

*30 January 2018*

# Contents

# *A CFC regime for Ireland (Consultation question 2)*

***"Article 7 of ATAD requires Member States to implement Controlled Foreign Company (CFC) rules by 1 January 2019. What are the key considerations regarding the implementation of CFC rules? In terms of the options for CFC legislation set out in Article 7, what are the key factors in determining the preferred approach for Ireland?"***

# *A CFC regime for Ireland (Consultation question 2)*

## *Introduction*

# *Introduction*

## A fundamental change

- The introduction of CFC rules in Ireland represents a fundamental change in Irish tax legislation that will impact all stakeholders that have companies or operations overseas.
- As Ireland does not currently have CFC rules, the change will be more significant for Irish taxpayers than for taxpayers in many other member states that already have CFC legislation.
- At the outset, it should be noted that Ireland's 12.5% rate of corporate tax for trading activities does not, of itself, mean that genuine commercial activities in a foreign subsidiary could not be unintentionally caught by CFC rules designed without due consideration of the complexities that can arise. Some examples of this are:
  - Exemptions and/or tax holidays that are given to newly incorporated "start up" companies – similar to rules currently in operation in Ireland.
  - OECD compliant incentives that are provided to attract investment.
  - Up-front full expensing of capital assets (e.g. as recently introduced in the US).

# Introduction

- These are just a few examples of scenarios where commercially motivated foreign subsidiaries of Irish companies could be considered CFCs and suffer an income inclusion in Ireland, as they meet the taxation condition due to differences between the Irish and foreign tax base. It is imperative that Ireland focusses carefully on what income should fall to be included as CFC income and taxed in Ireland.

## CFC rules for a broad base of stakeholders

- PwC have a broad base of clients and have discussed this matter across a wide variety of sectors, including domestic Irish companies, Irish plcs, FDI MNCs, and a range of financial services industries.
- From these discussions, while there is recognition that Ireland must meet the requirements of the Directive, it is clear that different groups and sectors have a preference for differing approaches that could be taken by Ireland when implementing CFC legislation.

# *Introduction*

- The Directive sets out options for each member state to consider. The single biggest decision will be the method that Ireland chooses to determine how CFC income should be categorised.
- It is important to note that the two options provided in the Directive have pros and cons, but neither, in isolation, offers a route for Ireland to both meet our policy goals and to remain competitive among our peers. Furthermore, the Directive merely sets out a framework for the rules and doesn't deal with many of the complexities of such regimes, nor the interaction with the rest of the corporation tax system.
- CFC rules are complex, and in all jurisdictions that have such rules they are designed to ensure that only income that raises policy concerns for that country is targeted. In order to achieve this, the architecture of the rules is necessarily complex, and goes beyond the simple language and scenarios set out in the Directive.
- Hence, it is important that Ireland does not simply transpose the wording of the Directive directly into legislation, as to do so would lead to significant uncertainty as to when the rules would actually apply.

# *Introduction*

- It appears from recital 12 of the Directive that this is accepted by the EU with the important point being that a country must choose rules which match their "*policy priorities*", ensuring that the rules are a "*proportionate response to BEPS concerns*". It is critical that this is borne out in the design of rules for Ireland.
- Further, as the avoidance of Irish tax by artificially shifting profits to low tax subsidiaries has never been identified as a significant policy concern for Ireland, it is important that the rules introduced are suitable for all stakeholders.

# *Introduction*

## Our Approach

- In our view, in introducing a CFC regime, three of Ireland's key policy goals should be as follows:
  - Ireland should only seek to tax profits that are artificially diverted from Ireland. This is in line with our long-standing stated policy position, which Ireland strongly defends.
  - Ireland should always recognise substance in subsidiary locations in a similar manner to which Ireland expects other jurisdictions to recognise substance here.
  - Ireland should seek to provide certainty and not impose an undue administrative burden on taxpayers, particularly when there is clearly no BEPS concern.
- The approach that we have outlined below offers Ireland the opportunity to implement rules that only seek to tax the profits of foreign subsidiaries in scenarios where those profits have been diverted from Ireland in a wholly artificial manner, and meet the three policy goals set out above.

# *Introduction*

- Our approach is centred on Option B, with a number of complementary exemptions designed to ease the compliance burden in cases where there is clearly no risk of artificial diversion of profit. This approach should meet the minimum standard within the Directive, while not preventing the inclusion of income that arises from non-genuine arrangements put in place for the essential purpose of obtaining a tax advantage.
- Option B, the so called "transactional approach", was endorsed by the OECD in their Action 3 report, where at paragraph 97 it says that *"..the transactional approach is generally more accurate at attributing income [and] it is better able to target specific types of income [which] suggest that the transactional approach may be more consistent with the goals of Action 3 and EU law."*
- However, Option B does have some drawbacks.  Therefore, without adopting all elements of the proposed design set out below, Ireland risks introducing a regime which is not consistent with settled policy, does not provide a level playing field that is fair and equitable for all taxpayers, and could adversely impact Ireland's international competitiveness.

# *A CFC regime for Ireland (Consultation question 2)*

## *Suggested design of the rules*

# A CFC regime for Ireland

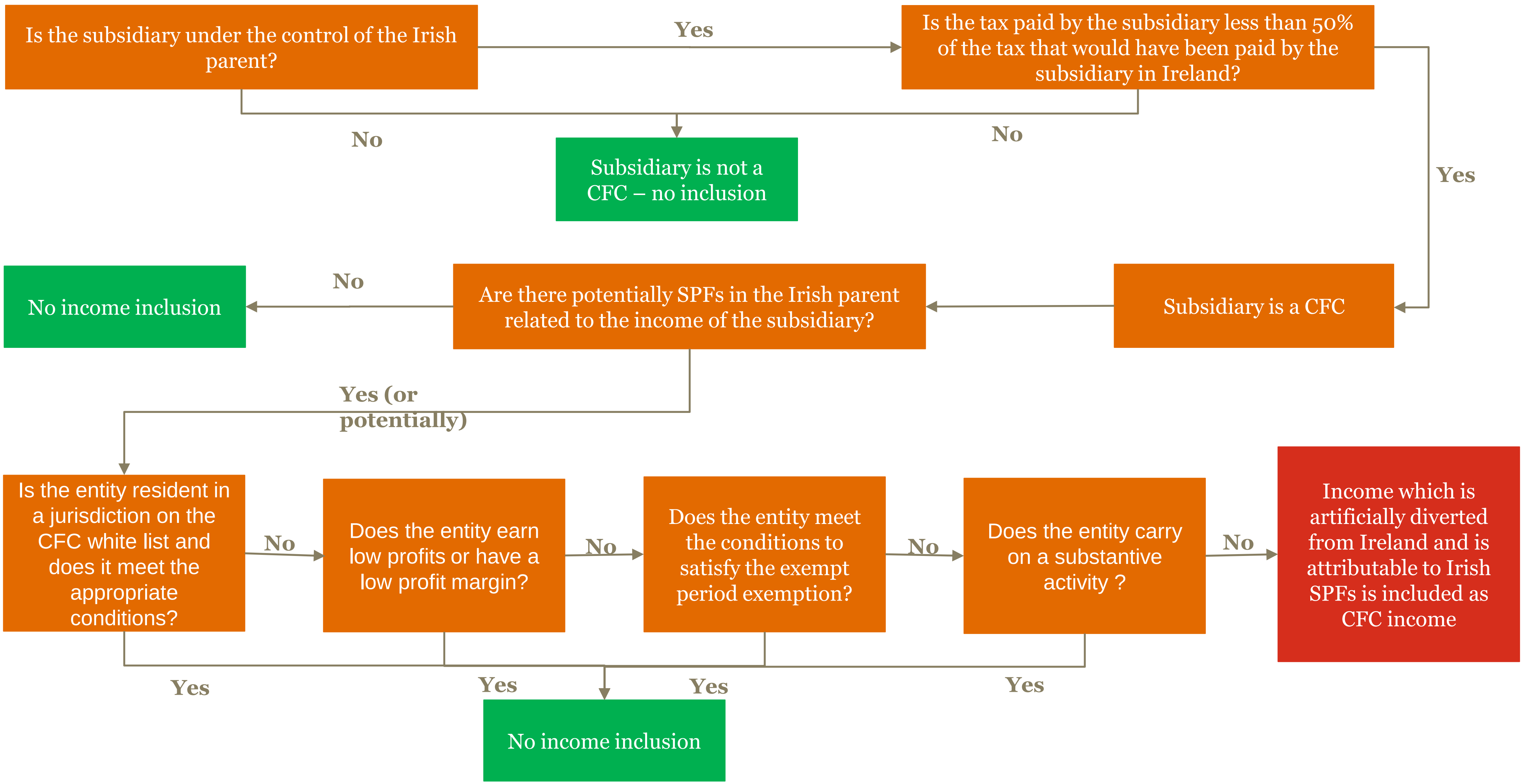
**Is the subsidiary a CFC ?(participation and taxation conditions)**

**Income inclusion determined by Option B Test subject to:**

**Entity level exemptions**

- Exempt Period
- White List
- Substance-Based Exemption
- Low Profits Exemption
- Low Profit Margin Exemption

# A CFC regime for Ireland – income inclusion decision tree



# *Meeting Ireland's Suggested Policy Goals*

| Policy Goal | CFC measure |
|---|---|
| Taxation of profits attributable to Irish activities | Ensuring that the income attributable is only that which could be attributable to **SPFs** in Ireland |
| Recognition of substance in all subsidiary locations | The inclusion of a **substance-based exemption** from the main SPF rule |
| Provision of certainty and reduction of compliance burden | **Entity level exemptions** (white lists, exempt period, low profits/low profit margin) – based on approaches provided for in the Directive and adopted elsewhere |

## An Option B (SPF) test

**Policy Rationale**

- This option focusses on profits that are artificially diverted from Ireland, allowing a focus on base erosion of the Irish tax base, and as such offers a good starting point for the CFC rules.
- Similarly, Ireland should look to ensure it remains in line with other jurisdictions that already have, or may introduce, an Option B style approach.
- This option provides a “bright-line” test for companies in Ireland in relation to the income of any CFC subsidiaries, and therefore ensures that Ireland remains competitive as a headquarters jurisdiction.
- From a compliance perspective, this option does not require a detailed consideration of the type of income earned by CFC subsidiaries, the so-called “categorical approach”. Option B does not distinguish in terms of the location of the subsidiary.

# *A CFC Regime for Ireland*

## An Option B (SPF) test

**Policy Rationale Cont'd**

- However, Option B does have some drawbacks in scenarios where there are "SPFs" in Ireland that may be related to the income of foreign subsidiaries, even where such operations have substance, and are genuine in nature.
- This will likely always be the case for Irish indigenous business and plcs that are generally centrally run from a strong head office in Ireland. This could also be the case in non Irish headquartered MNCs and certain financial services groups.
- In such scenarios, the activities of the CFC must be proportionately compared with those undertaken in the parent location, which will lead to significant uncertainty, especially given the lack of clarity and guidance around the term "SPF".

# *A CFC Regime for Ireland*

## An Option B (SPF) test

**Policy Rationale Cont'd**

- Indeed, in such scenarios, the Directive seeks to apply an arm's length test to determine the income, irrespective of the fact that the income of the CFC would be calculated after any necessary transfer pricing adjustments, which themselves should also be calculated on an arm's length basis.
- The drawbacks identified above are dealt with by providing clarity and administrative ease through the various entity level exemptions explained in more detail below.
- The Directive is arguably unclear as to whether the mere provision of capital to a subsidiary could indeed subject the income of that subsidiary (if it were a CFC) to Irish tax. It should be clarified in the legislation that the mere provision of funding or capital does not give rise to attributable income for CFC purposes.

# A CFC Regime for Ireland

## Entity level Exemptions

**Policy Rationale**

- In scenarios where there may be SPFs in the parent location, entity level exemptions, that recognise that in certain circumstances it is clear that a CFC has been established for genuine commercial reasons, and not for the essential purpose of obtaining a tax advantage, allow for a significant reduction in the compliance burden for foreign entities that do not pose a BEPS risk for Ireland.
- As a result of our 12.5% tax rate, the BEPS risks associated with the diversion of profits from Ireland to low/no tax jurisdictions has to date been low – as such, it is crucial that the introduction of CFC legislation, to meet with the minimum standards of ATAD, does not impose undue administrative burden and costs on taxpayers and the Revenue Commissioners.

# *A CFC Regime for Ireland*

**Substance-Based Entity Level Exemption**

**Policy Rationale**

- Applying a substance-based carve-out allows Ireland to adopt rules that do not seek to penalise substantive activity and genuine arrangements, in line with one of the core tenets espoused by the BEPS project, and this is one of Ireland's long held economic policy objectives.
- The final Action 3 report, at paragraph 22, addressed this point specifically in an EU context:

  *"Including a substance analysis would only subject taxpayers to CFC rules if the CFCs did not engage in genuine economic activity"*

# A CFC Regime for Ireland

## Substance-Based Entity Level Exemption

**Policy Rationale cont'd**

- Ireland has sought to attract substance-based investment, and has consistently stated that true substantive operations should be recognised by other countries – indeed this has been a central pillar of Irish tax policy for more than 50 years. As such, Ireland should similarly recognise substance in other locations (which again is consistent with the policy goals of BEPS).
- To the extent that there are people in Ireland that are significantly involved in the generation of the income earned by a subsidiary, the application of transfer pricing should generally result in an appropriate portion of that income being attributed to Ireland without the need for CFC reclassification.

# A CFC Regime for Ireland

## Substance-Based Entity Level Exemption

**Policy Rationale cont'd**

- The inclusion of a substance-based carve-out would also ensure that Ireland would not seek to tax anything other than wholly artificial arrangements. From an EU law perspective, this would help ensure that Ireland's rules would be compatible with the judgement of the Cadbury Schweppes case. Paragraph 20 of the BEPS Action 3 paper supports this by stating:

*"In Cadbury Schweppes, and subsequent cases, the ECJ has stated that CFC rules…..must specifically target wholly artificial arrangements which do not reflect economic reality and whose only purpose could be to obtain a tax advantage."*

# *A CFC Regime for Ireland*

## Exempt Period

**Policy Rationale**

- An exempt period entity level exemption should be adopted as part of the rules to ensure that Irish companies are not unduly penalised in the event of an acquisition.
- To the extent that an Irish company acquires a foreign entity or entities that would fall to be taxed under the Irish CFC rules for the first time, a 2 year period should be allowed for the Irish parent company to restructure as necessary before the income of these entities is brought into the Irish tax net as CFC income. Such a rule would obviously be subject to anti-avoidance.
- This is a design feature of other CFC regimes.

# A CFC Regime for Ireland

## White List

**Policy Rationale**

- Paragraph 12 of the recitals to the Directive are supportive of the adoption of such lists:

  *It should be acceptable that, in transposing CFC rules into their national law, Member States use white, grey or black lists of third countries, which are compiled on the basis of certain criteria set out in this Directive and may include the corporate tax rate level, or use white lists of Member States compiled on that basis.*

- White lists are a common element of CFC regimes in other locations and, without the clarity provided by such a list, Ireland may lose a competitive advantage to certain other jurisdictions. It should also be noted that white lists are dynamic, and can be changed as tax regimes change, or policy concerns shift.
- Given Ireland's relatively low headline corporate tax rate, there are numerous countries that do not represent BEPS risks from an Irish perspective.

# *A CFC Regime for Ireland*

## White List

**Policy Rationale cont'd**

- There are also jurisdictions which do not ~~a~~ represent a BEPS risk but, due to taxation mismatches in the rules between Ireland and the foreign jurisdiction, could result in scenarios where the tax paid in a year is less than half that which would have been paid in Ireland. A topical example of this is the US, where, due to new rules on full expensing of capital expenditure, an entity could pay significantly less tax in a given year than would have been paid in Ireland. However, it is generally accepted that a group would not set up operations in the US to gain a tax advantage.
- As such, in order to ensure that the compliance burden related to these jurisdictions is mitigated, a white list should be adopted. Consideration should be given to whether the white list, which would include all countries where it is clear that operations have been established for commercial reasons, should be supplemented by a "grey" list of further territories where the bona fide intent is clear, provided that the entity is not availing of a special regime or other benefits which may have a tax avoidance purpose.

# A CFC Regime for Ireland

| Low Profits | Low Profit Margin |
| --- | --- |

**Policy Rationale**

- Subsidiaries with both low profits and low profit margins (as defined in the Directive) do not pose profit-shifting risks, and thus should be excluded from CFC.

# A CFC regime for Ireland (Consultation question 2)

## Other considerations

# *Other considerations*

1. The mismatch in tax rates for active and passive business operations could result in a lack of clarity and certainty for taxpayers. For further consideration of this point, we draw your attention to our detailed response to the Coffey Consultation.
2. Where possible, in assessing whether an entity is a CFC, consideration should be given to the overall commercial position in any particular jurisdiction, particularly in circumstances where it is not possible to wholly align substance and profit generation in the same entity (e.g. banking covenants or workers council issues, etc.). This could form part of the design of a substance-based exemption as discussed earlier.
3. The different application of CFC rules by jurisdictions in an ownership chain could result in double taxation concerns.
4. The very short time period between the finalisation of the legislation for CFC rules and the effective implementation date will mean that companies will not have time to assess the impact of the rules and their interaction with other Irish rules (and indeed CFC rules in place in other jurisdictions) before they come into force. Similarly, the compliance burden associated with the introduction of CFC rules will be significant for taxpayers and Revenue alike. As such, we would suggest that transitional arrangements are included to recognise these issues, and allow taxpayers to ensure that they can be compliant with the rules within a reasonable timeframe.

# *Participation Exemption (Consultation question 10)*

***"With the introduction of CFC rules under Article 7 of ATAD, the Coffey Review recommends that "consideration should be given to whether it is appropriate to move to a territorial corporation tax base in respect of the income of the foreign branches of Irish-resident companies and, in respect of connected companies, the payment of foreign-source dividends."***

***Would moving to a territorial corporation tax base be a positive development for Ireland? What would be the effects for Ireland of such a move?***

***To what extent does Ireland's ultimate choice of how CFC rules are implemented under Article 7 of ATAD impact on the question of moving to a territorial corporation tax base?***

***The Coffey review recommends that should Ireland not move to a territorial corporation tax base, Schedule 24 should be simplified on a policy and tax neutral basis. Could such a simplification be an appropriate alternative to a territorial corporation tax base, particularly in the context of specific CFC implementation choices? How might such simplification be achieved?"***

# *Participation Exemption*

**A Participation Exemption for Dividends and Branches**

- A move to a territorial regime would bring Ireland into line with OECD norms.
- Territorial regimes are easily understood and, in certain circumstances, remove the complexities that accompany the current foreign tax credit system, especially in the common scenario where the credits lead to an effective exemption.
- The policy argument against the introduction of a participation exemption has always been that our system does not currently have CFC legislation, hence the introduction of CFC rules in Ireland should be accompanied by a participation exemption for both dividends and branches.
- Ireland needs to remain competitive in order to continue to attract investment. This is even more critical in terms of investment that we are competing for, with other EU nations, as a result of Brexit. The introduction of a participation exemption for both branches and dividends could help to achieve this goal, but only if the rules are drafted in a manner to ensure that the regime aligns itself to Ireland's policy goals.
- The introduction of such a regime is unlikely to have a material impact from an Exchequer perspective as the low corporate rate coupled with the credit system, particularly the pooling of foreign tax credits in certain scenarios and the additional tax credit for dividends, often results in no incremental Irish tax on the income. In 2015, over 95% of the received foreign dividends returned by corporates were reported to be taxable at 12.5% (c.€7.6bn). Of this, the total foreign tax credits claimed amounted to c.€1.2bn.

# *Participation Exemption*

**Design of the Rules**

- A participation exemption regime, for both dividends and branches, should be linked to the rules outlined under the CFC regime, so that only income that is artificially diverted from Ireland is taxed, which would help maintain the integrity of each regime.
- The jurisdictional reach of the participation exemption for dividends and branches should be broad, and should not have a territorial limit where genuine substantive activity is taking place. This would be consistent with the approach adopted under Section 21B TCA 1997, relating to the rate of taxation for certain foreign dividends.
- This approach would allow Ireland to recognise the importance of "trading" or substance-based profits, and would allow Ireland to follow the well-worn position of providing that trading profits, irrespective of where they were earned, would be exempt.
- As is the case in a number of competitor jurisdictions, the participation exemption for branches should be optional for the taxpayer, to allow for flexibility when a company chooses to expand into a foreign jurisdiction through a branch.

# Participation Exemption

**Schedule 24**

- It will also be necessary to amend and update Schedule 24 TCA 1997, as there will be instances where the conditions of the participation exemption are not met, or a branch election is not made. In such a scenario, the reliefs from double tax in Schedule 24 will continue to be essential.
- This review, along with the breadth and speed of reform across numerous jurisdictions, also provides the opportunity to consider whether the provisions of Schedule 24 provide the appropriate protections against double taxation. We would be happy to engage further on this point.