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ATAD Implementation – CFC Feedback Statement
Business Tax Team
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28 September 2018

CFC Feedback Statement

Dear Sir/Madam

We refer to the Feedback Statement issued by the Department of Finance on 7 September 2018 and our ongoing dialogue on Ireland's policy stance regarding controlled foreign company ("CFC") rules. We welcome the opportunity to respond to the consultation set forth in that document. It is particularly welcome given this time of rapid change in international tax rules. Indeed the Coffey Report recommends pro-active consultation and our submission in response to the Coffey Report suggested a phased approach to such consultation, including early dialogue with stakeholders to enable them to understand policy priorities and allow constructive engagement on issues such as impact on competitiveness and providing stability and certainty to investors.

We appreciate that Ireland is bound by EU law to implement the EU Anti-Tax Avoidance Directives ("ATAD") by legislating for CFC rules. It must do so in compliance with the terms that are set out in ATAD and will stand up to scrutiny. It is reasonable that Ireland should do so in good faith by guarding against obvious weaknesses, even if these appear to be permitted by ATAD. We do not see a need to go beyond that standard consistent with previously stated policy positions on ATAD by Government. It is worth recalling that as recently as October 2013 Ireland did not see the implementation of CFC rules as a policy priority in the context of the protection of the Irish tax base.

Of course, the Corporation Tax Roadmap has already indicated that Ireland will adopt "Option B" for CFC rules. In overall terms the Feedback Statement is a helpful exposition of some details of the key concepts underlying the policy choices that are being made to give effect to Option B. This is particularly welcome given the short time left for business to understand the implications, particularly those businesses that may have financial reporting obligations to the financial markets in early 2019.

The helpful aspects of the Feedback Statement include the following:

- The further detail on the policy choices selected within Option B (e.g. confirmation that the *de minimis* thresholds will be included in the detailed legislation).

- Confirmation that transfer pricing rules, ensuring that trading activities undertaken in Ireland are rewarded on an arm's length basis, are to take priority over CFC rules.

J Bollard, N Byrne, B Cassidy, I Collins, S Connellan, S Doherty, S Downey, J Heffernan, R Henson, D Hogan, E McCallion, K McLoughlin, N O'Beirne, C O'Donovan, F O'Neill, D O'Sullivan, J Ryan, C Vaughan, Ernst & Young Ireland.

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- Laying out of key expressions such as ""significant people functions" and "essential purpose".

- Confirmation that the applicable tax rate will be 12.5% if the CFC income arose from a trade or 25% for passive income (in passing we notice that the lack of reference to capital gains implies that these are outside the scope and some confirmation of this would be welcome).

- The 'exempt period' for newly acquired CFCs.

CFC Legislation & Revenue Guidance

The Feedback Statement does not contain a number of key elements that businesses will wish to monitor closely as the Finance Bill passes through the Oireachtas. These include, but are not limited to, the following:

- Some parts of the charging mechanics.

- Definition of "creditable tax" for the purposes of the CFC charge.

- Clarity on whether a "white list" approach will be available and if so what additional conditionality might apply besides the CFC country of residence.

- Provision dealing with previously taxed income (so that it is excluded from charge under Schedule D Case III when eventually distributed in the form of a dividend to the Irish parent).

- Returns, assessments, appeals and related administrative provisions.

When the draft legislation dealing with these areas is presented to the Dáil we may have technical comments to share with you, and we will do so promptly at that time.

In addition, we anticipate there are practical matters of interpretation that are most properly directed toward the Revenue Commissioners. We recommend that dialogue with the Revenue Commissioners as to the content of such guidance take place with all relevant stakeholders as soon as possible.

In the meantime we have set out below comments on the framework text included in the Feedback Statement. Some more detailed comments of a technical nature are included in the Appendix.

"Cash boxes"

There is uncertainty over the policy intent and scope of the statements regarding "cash boxes". The idea that Ireland might have a special rule which goes beyond the provisions of ATAD was first made public with the release of the Tax Strategy Group papers on 31 July. In this context we have the following comments:

- Raising the issue without detail has created uncertainty, although we respect the reasons for the thought process taking place.

- Implementation of such a rule by 1 January 2019 risks sub-optimal outcomes due to the lack of available time for consultation on scope etc. as well as imposing a significant burden on businesses to consider its effects and how to respond.

- At present Ireland taxes dividends from a passive company out of its passive income at 25% and this has always been considered a sufficient safeguard against "cash boxes".

- The Corporation Tax Roadmap issued by the Department of Finance on 7 September suggests that Ireland's regime for taxing dividends from foreign subsidiaries is to be the subject of public consultation in early 2019.

- For the reasons mentioned above we have concerns about introducing a rule that goes beyond what ATAD requires.

- The Coffey Report clearly indicates that Ireland's existing system of taxing the profits of the subsidiaries of Irish-parented groups raises issues of competitiveness, and that Ireland should consider making fundamental changes to that system.

- We therefore recommend fuller consultation on the "cash box" question as part of the consultation on a possible transition to an exemption system. The Corporation Tax Roadmap indicates that such consultation is to take place in early 2019.

- In any event any action on 'cash boxes" would need to respect the EU's fundamental freedoms, which might require an exception for substantive economic activities, in line with the *Cadbury Schweppes* decision.

"Significant people functions" ("SPFs")

Ireland has chosen to implement "Option B", a CFC framework which is focused on applying Irish tax to income that has been artificially diverted from Ireland in the sense that it is linked to SPFs that are performed here. In this context Recital (12) to ATAD states:

> *"… in order to ensure that CFC rules are a **proportionate** response to BEPS concerns, it is critical that Member States that limit their CFC rules to income which has been artificially diverted to the subsidiary 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."*
> [Emphasis added]

In the body of ATAD this formulation of "most of the decision-making functions" has been paraphrased as a reference to SPFs that are "instrumental" in generating the income. This approach has also been adopted in the text in the Feedback Statement.

We recommend that the "most of …" formulation be used in Irish legislation. This formulation is consistent with what ATAD expressly states to be a proportionate response, and it offers a more objective approach. There are already methodologies which can be used to compare the relative importance of SPFs so as to allow for an evaluation as to whether the "most of" test is met, but it is not clear how "instrumental" would be evaluated.

Guidance on the application of the SPF definition to common situations would also be welcome, e.g. how the test applies to dividends received by an intermediate holding company.

"Essential purpose"

In its terms ATAD only requires CFC rules to apply to arrangements *"which have been put in place for the essential purpose of obtaining a tax advantage".* We read this to be a higher threshold than a test of "the main purpose". This is a point on which guidance would be most helpful, perhaps along the lines of the guidance already provided by the Revenue Commissioners on how to approach "main purpose" test.

Other items

The Appendix to this letter contains a number of other items of a more technical nature for your consideration as the legislation progresses.

As always, we would be happy to discuss these points further at your convenience.

Yours sincerely

JOE BOLLARD

Partner – Head of International Tax Services

Appendix

CFC Feedback Statement – technical issues for further consideration

"Control"

1. The Feedback Statement proposes a definition of 'control' based on s432 TCA 1997. This appears to be a very expansive definition, going beyond what ATAD requires. Section 432, being part of Ireland's close company legislation, has a quite different purpose, and requires significant adaptation to be fit for purpose. Retaining its complexity risks unintended consequences (e.g. in joint venture arrangements). Section 11 TCA 1997 contains a definition that is much closer to what ATAD requires. We recommend that the definition of "control" used should stand on its own, and should use the language in s11 as a starting point.

2. If that recommendation is not accepted, then even using the definitions in s432, it is unclear why there should be a difference in the extent of attribution of control to an "associate" (e.g. as to assets on a winding-up) as compared to other categories.

"Foreign tax paid"

3. As well as the more obvious items this definition will need to deal with situations analogous to group relief and foreign fiscal consolidations. By way of illustration, a UK resident subsidiary of an Irish holding company might claim group relief under the UK tax system. How tax will be deemed to be paid in such situations should be clarified. Related questions arise under Scandinavian-style "group contribution" arrangements and fiscal consolidations where a single entity pays tax on behalf of all group members.

"Corresponding Irish corporation tax"

4. Given the effective tax rate test involves comparing this amount with the foreign tax paid it is important that the two measures are computed on a similar basis. But there are inevitably areas where the two must diverge. For example 'foreign tax paid" might include withholding taxes, but depending on the countries involved the withholding tax suffered might be much higher if the income was received by an Irish resident company.

5. Again, some thought should be given to the issues presented by tax groups. This will include taking on board the comments made under the heading "Foreign tax paid".

6. The text requires an assumption that the most favourable claims/elections have been made. It will often be the case that there is no single answer to what is the most favourable election, e.g. where optional elections exist. This area may require further clarification.

The CFC charge

7. There is a clear intention to limit the CFC charge to the shareholding proportion of the Irish parent (or entity performing the SPFs). It is not clear how that proportion is to be established, particularly where there are multiple share classes.

8. We do not see a compelling reason to prevent the CFC inclusion from being sheltered by Irish losses (or related items such as management expenses, charges on income, excess capital allowances) in the same way as any other source of income. ATAD does not require this ring fencing, and it is noted that other jurisdictions do not have this feature in their CFC regimes.

9. The exclusion for "essential purpose" seems more restrictive than set out in ATAD in that it results in a "tainting" of all income of a CFC for an accounting period where there is **any** arrangement that fails the test. It seems clear to us that ATAD requires the "essential purpose" test to be applied to each "arrangement" and the related income without regard to any other "arrangements".

10. The text contemplates the possibility that there may be more than one Irish entity performing SPFs. As written this would result in a proportionate CFC charge on each of them. This results in incremental compliance cost without any benefit to the Exchequer. Accordingly we recommend that taxpayers be permitted to elect that the CFC charge for all entities be levied on a single Irish company. This has the same result for the Exchequer and simplifies compliance.

11. There is an exclusion for situations where the CFC bearing the risks and owning the assets has produced "negligible" results. Clarity on how the negligible test is to be interpreted would be welcome.

12. There are some exclusions by reference to the arm's length standard. In this context there is no definition of the arm's length standard (we assume there will be a cross-reference to the existing piece of legislation that imports the OECD Transfer Pricing Guidelines). It is not clear what result flows if a CFC inclusion is required and the CFC's results do not arise from transactions at arm's length.

"Exempt period"

13. Essentially this allows a "grace period" of 12 months following an acquisition allowing the new Irish parent to regularise the status of a pre-existing CFC of the acquired group. However, the provisions that prevent doing so through an increase in activity appear to go further than the policy objective requires. We also have concerns that the text may need to be adjusted to ensure it respects the EU fundamental freedoms.

"Undistributed income"

14. The formula of A x B/C at first sight requires B and C to be comparable measures for the formula to work properly. Based on the definitions available it is not clear whether this is so, and we look forward to clarification on this.

15. It seems harsh to have no regard to the situation where there is a legal prohibition on distributing the profits of a CFC. The policy objective could perhaps be dealt with through a targeted anti-avoidance rule

16. As a practical matter, e.g. due to local law formalities, it may be difficult to pay a dividend within the nine-month period set out, and indeed to evaluate the position at the time of filing the corporation tax return of the chargeable company. Some form of administrative solution for this should be considered for example (a) extend period in which dividend can be paid or (b) allow a refund of CFC tax paid where a qualifying dividend is paid in the following accounting period.

17. There is wording to ensure that the CFC charge is only reduced by a dividend payment where that payment is itself taxable. The actual wording used seems to go further than intended. For example if a CFC paid a dividend to its Dutch intermediate holding company that might not be sufficient even if that was dividend was taxable in the Netherlands. This is presumably unintended, but the Dutch participation exemption means that a Dutch recipient could disqualify the dividend, even if it was **actually** taxable because the participation exemption was unavailable.

18. We suggest further consideration is given to greater clarity in the law as to what is meant by a dividend paid "in respect of an accounting period". Given the significance of the term, taxpayers will need to determine with certainty whether a dividend paid in an accounting period should be regarded as having been made in respect of that accounting period or a prior period.

Miscellaneous

20. The definition of "controlled foreign company group" suggests there is an intention to aggregate the CFC inclusions into a single CFC charge. As a simplification measure we would welcome this, consistent with our comment at 11 above. We would welcome some clarity on this.

21. The framework appears to be to include CFC profits arising in an accounting period of the CFC that ends within the accounting period of the Irish parent. If the law is to apply in this form to periods straddling 1 January 2019 some clarity will be required as to whether the profits will need to be apportioned as to before and after 1 January 2019. Clearly this is not necessary if the CFC rules are effective for accounting periods beginning on or after 1 January 2019.

22. Both in the discussion of the CFC charge and in the definition of "undistributed income" there is a reference to a "reasonable attribution" of income to SPFs. This raises two points. First, it seems unnecessary to make this attribution twice. More importantly, ATAD does not proceed from the assumption that income is attributed to SPFs. Instead it respects the basic transfer pricing construct that income rewards assets and risks, and then seeks to treat those assets and risks as "linked" or "relevant" to SPFs. Importantly, to reiterate an earlier comment, the attribution should only arise in any event where most of the decision-making functions are in fact in Ireland in line with what ATAD states to be a proportionate response to the policy objective.