TSG 12/18

Tax Strategy Group
International Financial Services

1. Introduction

The Programme for Government pledged to support the ongoing development of the International Financial Services (IFS) industry as a source of future employment growth, subject to appropriate regulation.

In 2011 the Taoiseach launched the *Strategy for the International Financial Services Industry in Ireland 2011-2016*, which identifies a transparent and competitive tax framework as a key driver in ensuring the growth and prosperity of the Irish financial services sector. A strong confirmation of the Government's support for the industry was provided in Finance Act 2012, which introduced a range of measures to support the ambitious jobs targets contained in that Strategy.

Taken together with the Special Assignee Relief Programme and Foreign Earnings Deduction, these measures represented a significant package to support the competitiveness of the international financial services industry in Ireland.

As the measures contained in Finance Act 2012 succeeded in resolving a large volume of smaller issues affecting the industry, the focus of the IFS tax strategy paper this year will be on a smaller number of larger scale items of more significant individual impact.

2. Contribution of the IFSC to the Irish Economy

The IFS sector is a significant success story within the Irish economy, and contributes significantly to the reputation of Ireland as a respected player on the world stage.

In the last year, the Irish funds industry passed two very significant milestones – it now has over €1 trillion in Irish domiciled investment funds, and over €2 trillion in total assets under administration. Ireland administers 40% of all global hedge funds; 32% of the total European ETF market are domiciled in Ireland; and Irish domiciled money market funds represent approximately 30% of the total European money market assets.[1]

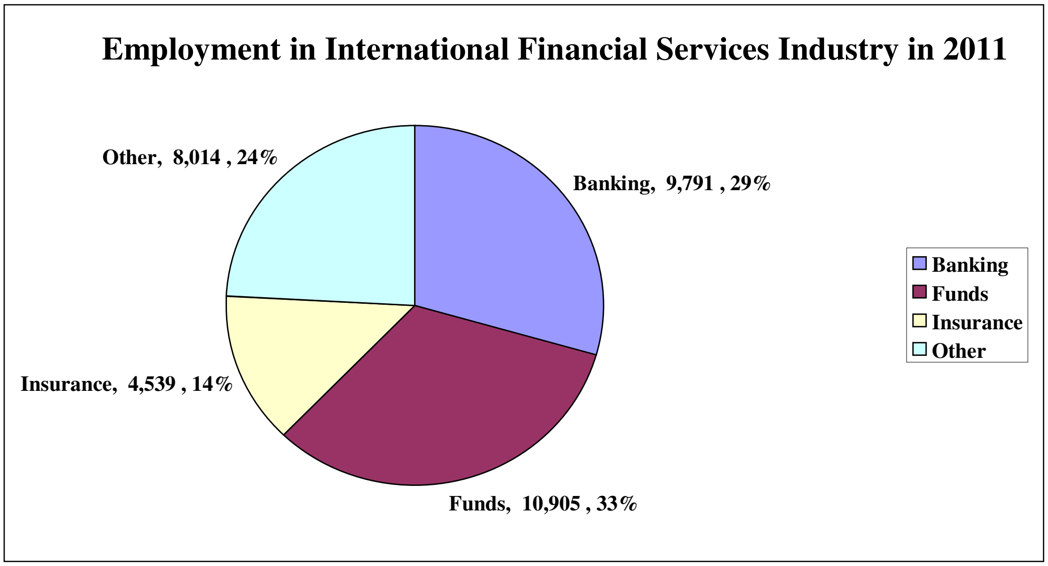
Aircraft leasing companies based in Ireland manage $150 billion in assets, accounting for 19% of the global fleet of c.18,000 commercial aircraft. Ireland is the largest provider of cross-border life insurance in the EU with premiums of €16.4bn in 2009.[2]

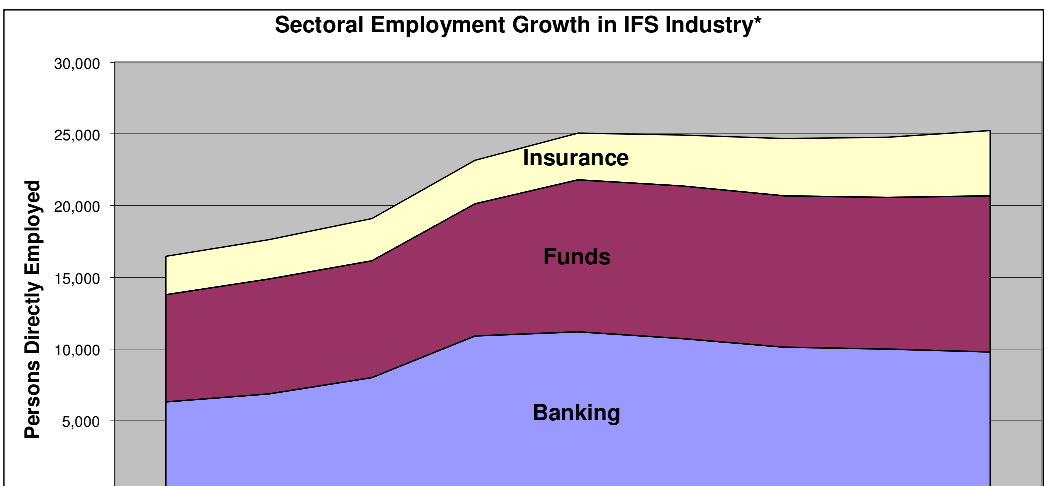
The IFS sector continues to make a significant contribution to the Irish economy in terms of both employment and corporation tax yield. Employment in the sector increased in 2011 for the second year in succession, with direct employment numbers growing by 1.9%

[1] Source: Irish Funds Industry Association
[2] Accenture Report – *The IFSC- the international financial services centre in Ireland*

to reach 25,235, a new all-time peak in direct employment for the sector.[3] When employment in related services is taken into account, the overall employment figure rises to over 33,200 employees.[4] The breakdown of these employees across the various sectors is illustrated below.

The increase in employee numbers in two successive years is a very positive sign of recovery in the IFS sector, and is an important step on the road to achieving the aim to create 10,000 net new jobs announced in the *Strategy for the International Financial Services Industry in Ireland 2011-2016.*



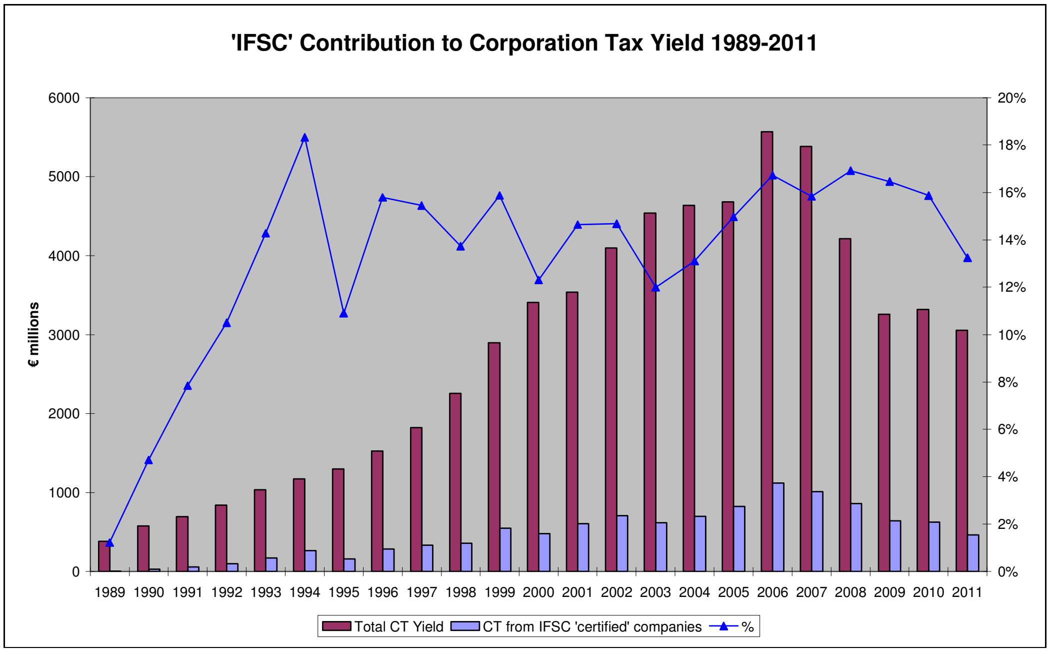


	2003	2004	2005	2006	2007	2008	2009	2010	2011
Insurance	2,673	2,722	2,943	3,027	3,268	3,526	4,011	4,185	4,539
Funds	7,476	8,017	8,144	9,227	10,599	10,651	10,560	10,582	10,905
Banking	6,310	6,871	8,008	10,902	11,191	10,729	10,121	9,994	9,791

*Source: *Finance Dublin Employment Surveys 2004 - 2011*

[3] Source: Finance Dublin Employment Survey – June 2012
[4] A joint Financial Services Ireland / Accenture Report – *The IFSC in Ireland, 2010* – estimates 8,014 people employed in certain support services and niche industries such as professional services, IT and outsourcing, payments and corporate treasury.

The Revenue Commissioners estimate corporation tax paid by international financial services companies established pre-2003 to be in the region of €466 million in 2011 – 13% of total yield. This figure only includes corporation tax yield from companies who were previously certified under the 10% IFSC regime, and is therefore an underestimate of the full contribution of the industry to corporation tax yield to the extent that it excludes companies established since the end of 2002.



3. EU Commission Proposals for a Financial Transaction Tax (FTT)

The European Commission published a proposal on 28 September 2011 for a Directive on a common system of Financial Transaction Tax (FTT). The stated goal is to ensure that financial institutions make a fair contribution to covering the costs of the recent crisis, and to ensure even taxation of the sector vis-à-vis other sectors.

The Minister for Finance has stated his view that an FTT would be best applied on a wide international basis to include the major financial centres, and that if it could not be introduced on a global basis, it would be better if it were introduced on an EU-wide basis to prevent any distortion of activity within the Union.

At the ECOFIN meeting in June this year it became clear that an EU-wide FTT would not be agreed, and those countries who favour the tax will now try to introduce it by way of "enhanced co-operation", under which at least nine countries must participate. This requires those countries to write to the Commission asking it to produce a formal proposal to the Council for authorisation to proceed with the introduction of an FTT by enhanced co-operation. There is no such proposal as yet and as of 3 October only four countries (xxxxxxx, xxxxxxx, xxxxxx xxx xxxxxxx) have requested the Commission to start the process. However, it is believed that any revised proposal will not substantially differ from the original proposal.

Ireland will not be among the participating countries, but the Minister for Finance has stated that we will not stand in the way of those who want to introduce an FTT under the "enhanced co-operation" mechanism. However, the Minister has also indicated Ireland's principled opposition to dealing with tax measures under "enhanced co-operation".

The Department will continue to monitor discussions on the FTT to ensure the compatibility of any proposed measure with the internal market and with existing taxes on financial transactions, including our Stamp Duty; and with a view to protecting our existing financial services business.

If the enhanced co-operation proposal is published, Ireland will also be required to chair discussions during our Presidency on the FTT. We will be required to facilitate the proposal and act impartially, but also intend to have our concerns expressed and heard.

4. Budget & Finance Bill 2013 Submissions Focussing on the IFS Sector

In the context of Budget and Finance Bill 2013, we are considering submissions from:

- CHG Banking and Treasury Working Group Tax Sub-Group
- CHG Banking and Treasury Working Group International Asset Finance Sub-Group
- CHG Insurance Working Group Fiscal and Accounting Sub-Group
- CHG Funds Working Group Tax Sub-Group
- A&L Goodbody

It is intended to focus in this paper on substantial individual issues raised in the above submissions, and not on smaller technical points or points for clarification.

The key issues being considered are:

- Foreign Account Tax Compliance Act (FATCA)
- Foreign Branch Exemption
- Package of measures to support the funds industry in the context of AIFMD:
    - Recognition of tax transparency for the Investment Limited Partnership.
    - MiFID update to be dealt with by the issue of a Statement of Practice (interim measure, with legislative amendment to s.1035A to follow).
- Enhancement of the foreign tax credit regime to allow pooling and carry-forward of foreign tax credits on equipment lease rentals.
- Real Estate Investment Trust (REIT) vehicle for collective investment in property.
- Payments to Non-Treaty Jurisdictions

In addition, the following technical issue is also being considered:

- Islamic Finance – requirement that investment certificates are "issued to the public".

4.1. Foreign Account Tax Compliance Act (FATCA)

The US Foreign Account Tax Compliance Act (FATCA) is part of the US Hiring Incentives to Restore Employment Act of 2010, and is aimed at combating tax evasion by US citizens who hold assets offshore.

FATCA effectively amends the rules for all international financial institutions who do business with US citizens and, as a result, all countries who do business with the US generally. It requires that all Foreign Financial Institutions (FFIs) report to the US Internal Revenue Service (IRS) on accounts held by US citizens and tax residents. Any FFI that fails to report will be charged a 30% withholding tax on all US source income and payment flows via the US.

FATCA poses significant concerns for the Irish IFS industry due to the very significant administrative burden involved in both entering into individual agreements with the IRS and in complying with the ongoing reporting requirements to the US authorities.

Similar concerns were indentified globally, and in the early part of this year the Governments of France, Germany, Italy, Spain and the United Kingdom (collectively referred to as the G5) took part in joint discussions with the US Government and IRS to explore a practical way forward that supports the overall aim to combat tax evasion, while reducing the risks and burdens on their financial institutions. These negotiations resulted in the US publishing a model Intergovernmental Agreement (IGA) at the end of July this year, which is to form the basis of all of their intergovernmental negotiations going forward.

Significant resources have been dedicated to FATCA by both Revenue and the Department of Finance, and engagement with the Irish IFS industry has been ongoing throughout 2012. Contact has been made with the US Treasury and the IRS with a view to negotiating an IGA on behalf of Ireland's financial institutions, with the aim of providing the Irish industry with an early-mover advantage in this sphere, giving certainty to their client bases in relation to FATCA.

Allowing for FATCA reporting to take place on a bi-lateral inter-governmental basis, rather than directly between the individual Irish financial institutions and the IRS, should also significantly reduce the administrative burden for the Irish industry. Negotiating the agreement at governmental level also allows for collective negotiation in relation to exemptions, and a level-playing field across the financial industry in Ireland.

While there is no scope for amending the vast bulk of the IGA, Annex II to the Agreement will specify the institutions and products which are exempt from FATCA. This annex will be tailored according to the different financial services systems in place in FATCA partner countries.

Ireland's aim at present is to conclude an Intergovernmental Agreement by the end of this year, and to implement the Agreement in Finance Bill 2013 and subsequent regulations.

4.2 Foreign Branch Exemption (FBE)

There has been a strong move in the insurance industry in recent years to transform subsidiaries into branches of one bigger European insurance carrier, driven both by market forces and the need to manage capital under the Solvency II Regulatory regime[5].

The Insurance Working Group members are therefore of the opinion that future Irish operations of insurance groups are likely to be either headquarter operations of substance, or small branch offices of foreign companies writing Irish business only. The difference in the number and quality of Irish jobs which would result from these two options is potentially significant.[6]

Following the introduction of the UK Foreign Branch Exemption in 2012[7], the industry believe that Ireland may be at a competitive disadvantage in attracting large financial services companies to headquarter their operations in Ireland. The Netherlands and Luxembourg, other key competitor jurisdictions for European headquarter locations, also operate FBE systems.

Professional advisory firms have also indicated that, in promoting Ireland as a jurisdiction in which to locate head-quarter operations, the lack of a FBE can be a significant factor which militates against consideration of Ireland. While it is acknowledged that the credit system allied to our low domestic rate of corporation tax largely results in an effective exemption for foreign branch profits, the difficulty, and indeed the necessity, of explaining this system may mean that Ireland has been removed from the HQ shortlist before the final decision phase is reached.

However it should be noted that a credit system based on full taxation with corresponding full deduction for branch losses against headquarter profits can be beneficial in certain circumstances, such as set-up or expansion stages when a branch is likely to be loss-making.

Current System of Taxation:

An Irish tax resident company is liable to Irish tax on its worldwide income, including the profits of a branch located in a foreign jurisdiction. The branch profits may also be subject to tax in the foreign jurisdiction, resulting in a double charge to taxation.

At present Ireland operates a credit system to allow relief from this double tax charge. Branch profits are subject to tax in Ireland, but a credit is allowed against the Irish liability for foreign tax paid on the same income. A credit may be allowed in respect of branches in both tax treaty countries (double tax treaty credit) and non-treaty countries (unilateral credit relief).

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[5] Solvency II is an EU legislative program to be implemented in all 27 Member States. It is a fundamental review of the capital adequacy regime for the European insurance industry, and aims to establish a revised set of EU-wide capital requirements and risk management standards that will replace the current solvency requirements.

[6] Per Department of the Taoiseach IFSC Insurance Working Group

[7] The UK provisions provide for an irrevocable 'opt-in' regime. The exemption applies to both profits and losses. The UK legislation runs to 23 pages, which illustrates the complexities of introducing a branch exemption.

In the case of a company with branches in a number of different jurisdictions, a branch pooling system is operated. Foreign tax paid on branch profits in all jurisdictions is pooled together, and the total credit is available for offset against the Irish tax liability arising from branch profits. This allows excess foreign tax credits from higher tax jurisdictions to be offset against any shortfall in credit on profits from lower tax jurisdictions.

The net result of the branch pooling system is that an additional Irish tax liability on branch profits should only arise if the average foreign tax rate applied to all branch profits is below the Irish corporation tax rate of 12.5%. As the Irish corporation tax rate is relatively low when compared with international corporate tax rates, it would be common for no further tax liability to arise in Ireland on foreign branch profits. This would be equivalent to the net effect of a foreign branch exemption system.

Practical Problems Arising from Timing Differences:

One of the motivations driving the request for introduction of a Foreign Branch Exemption is the difficulties which can arise when using the current credit system of relief from double taxation due to the different financial reporting rules applied to the calculation of taxable income and gains in various jurisdictions. For example, this can arise in relation to investment gains which may be taxed when arising in one jurisdiction, but when realised in another. In the insurance industry, significant timing differences can also arise in the deduction of insurance reserves, which may take years to unwind. Some of these reporting differences may cease when companies move from local GAAP to IFRS. Revenue have also indicated that the timing difference issues regarding payment of tax could be addressed by administrative practice.

Two examples of timing differences are outlined as follows:

- When the income or gain is recognised for tax purposes in Ireland in an earlier period than in the other territory, no foreign tax will be available for offset against the Irish tax liability as no foreign tax has yet been paid. When the income or gain is subsequently realised for tax purposes in the foreign territory there may be no Irish tax payable in that year against which to relieve the foreign tax.

- When the income or gain is recognised for tax purposes in the foreign territory in an earlier period than it is recognised in Ireland, the effect of the timing mismatch is mitigated by the ability to pool foreign tax credits for offset against liabilities arising from branches in other jurisdictions, and to carry forward remaining unused credits.

It should be noted that the introduction of a Foreign Branch Exemption is generally accompanied by Controlled Foreign Company (CFC) legislation, which may be required to prevent the artificial diversion of profits to exempt branches. Current discussions at EU level would support the view that any exemption should be accompanied by effective anti-abuse measures. CFC legislation, by its nature, is typically complex. Ireland does not at present have CFC legislation and this factor is often highlighted by HQ / holding companies as a benefit of the Irish credit system. It is not clear at this stage whether a FBE system accompanied by necessarily complex CFC rules would be more attractive than the current credit system.

It may also be difficult to introduce a CFC regime in Ireland without distinguishing between source countries by either a list system or on the basis of a threshold rate. Implementing a system that operates on the basis of the rate of tax in the foreign jurisdiction would be out of line with Ireland's general stance to date in this area. xxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxx.

As an alternative to FBE, it may be possible to address the timing difference issues through legislation. Two potential legislative methods to address this issue are:

1. Allowing a carry-back of foreign tax credit. At present, a situation can arise where foreign branch profits are recognised in Ireland before they are recognised for foreign tax purposes. This results in Irish tax being charged on the foreign branch profit with no foreign tax credit relief available (because no tax has yet arisen in the foreign branch). When that profit is subsequently recognised in the foreign jurisdiction, it may be the case the resultant foreign tax cannot be relieved in that period because the Irish tax in respect of that foreign profit arose in a previous period. Allowing a carry-back of foreign tax credits may address this situation.

   This would be a fundamental change and it could not be confined to the insurance industry alone, nor possibly to branch income. The only area of taxation that permits a carry-back is the treatment of losses. This amendment would have a cash-flow cost to the Exchequer and would be complex to administer.

2. Allowing for the use of the foreign measure of profits to be used to calculate either:
   a) The measure of branch profits for the purposes of Irish tax, or, failing this,
   b) The measure of certain specified items to be used when calculating profits for the purposes of Irish tax.

   In relation to the proposal at b) above, the insurance industry have identified the accounting treatment of the following three issues as being the most frequent cause of timing differences:

   a) Investment gains and losses.
   b) Insurance reserves.
   c) Deferred acquisition costs.

   Aligning the Irish tax base with the foreign tax base would again be a fundamental change in our taxation system. It is difficult to see how a foreign measure approach could or should be ring-fenced to insurance only. Attempting to ring-fence these provisions to specific insurance concepts such as outlined at a) to c) above would be problematic. It would result in the measuring of the foreign income of any individual insurance company according to multiple standards – normal trading profit according to either Irish GAAP or IFRS and the insurance specific items according to a range of foreign standards – and then relieving foreign tax suffered according to local GAAP/IFRS only. Maintaining effective oversight of the reliefs claimed could be difficult.

4.3 Alternative Investment Fund Managers Directive (AIFMD)

A key driver for the funds industry at present is the Alternative Investment Fund Managers Directive (AIFMD), a European Directive setting out rules for the authorization, operation and transparency of alternative investment fund managers (AIFMs) managing and/or marketing alternative investment funds (AIFs) in the EU.

By 2014, AIFs will have a single AIFM responsible for investment and risk management, who will be required to comply with significant requirements in relation to capital, organization and conduct of business rules.

AIFMD will also allow for AIFs authorised in one member state to be sold across the EU under a marketing passport, similar to the UCITS Directive for retail funds.

In order to prepare for the introduction of AIFMD, the Funds Industry Working Group have highlighted a need for investment structures that meet international investor needs, particularly in relation to tax. The Companies (Miscellaneous Provisions) Act 2009, which facilitated the re-domiciliation of funds into Ireland, was viewed by the industry as an important first step in allowing Ireland to be considered as a domicile of choice for AIFs.

Investment Limited Partnership:
The Limited Partnership structure is seen by the industry as a key ingredient for international investment, primarily in the case of private equity and hedge funds. As part of their pre-Budget submission, the Funds industry have requested that the tax transparency of the Irish Limited Partnership is recognised in legislation from both a direct tax and stamp duty perspective.

These issues are to be considered as part of a larger review of the Investment Limited Partnerships Act, 1994.

S.1035A:
In advance of the anticipated re-drafting of s.1035A TCA1997 following the Markets in Financial Instruments Directive (MiFID), it has been requested that Revenue issue a Statement of Practice to confirm that the existing "investment managers exemption" contained within the section be extended to encompass the activities of AIFMs managing AIFs.

4.4 Enhancement of the Foreign Tax Credit Regime to allow pooling and carry-forward of foreign tax credits on equipment lease rentals.

Foreign withholding taxes have been highlighted as a significant factor for the cross-border leasing industry in the choice of location for such businesses.

In instances where Ireland has no tax treaty with a foreign jurisdiction, or where a treaty exists which does not reduce the withholding tax rate to 0%, the Irish domestic law treatment of the withholding tax suffered is a key consideration.

Steps to address this issue were taken in Finance Act 2012, which introduced a new unilateral tax credit for such withholding tax, where credit relief is not available under a treaty. At present any excess credit arising under this relief cannot be pooled or carried forward. This is a cause of particular difficulty in the leasing industry for two reasons:

i) Capital allowances can cause significant timing differences between the occurrence of a withholding tax and the payment of Irish tax, and
ii) Due to the volatility of the industry, a portfolio approach is often used, which can result in some loss-making and some profit-making leases within the overall portfolio.

The leasing industry have indicated that they expect the cost of such amendments to be minimal as generally leases are structured to minimise foreign withholding taxes, typically by placing the leases in jurisdictions which give an optimal withholding tax position. However, further work on costing this proposal remains to be completed.

4.5 Real Estate Investment Trust (REIT)

A REIT is a widely-held, quoted company, used to invest in income-generating rental investment properties, and subject to a requirement to distribute a high percentage (80% - 90%) of rental profits to its shareholders.

At present, investors are discouraged from holding property via corporate structures in Ireland due to the double layer of tax which arises on income and gains arising therefrom. Corporation tax applies within a company on rental profits or chargeable gains arsing from investment properties, and then a second layer of tax occurs at shareholder level when net profits or gains are distributed out from the company.

A REIT is a structure which provides for a tax exemption on qualifying income and gains within the corporate vehicle, with tax to be paid by the investors on receipt of the required distribution of profits.

The purpose of a REIT is to provide an investment return for shareholders similar to that which would be received from direct investment in rental property, thereby removing the tax distortion described above. A second significant benefit of a REIT is that it can also provide the diversified risk and lower transaction costs associated with investing in a quoted collective investment vehicle.

It has been suggested that a key benefit to the introduction of a REIT regime would be the attraction of foreign investment capital into Ireland. This could however result in a total future loss of tax on rental income and capital gains for the State to the extent that REITs are sold to foreign investors in EU/DTA jurisdictions.

This tax loss would arise due to the exemption from Dividend Withholding Tax (DWT) which is available to shareholders resident in treaty partner countries in respect of dividends paid from Irish resident companies. Additionally, any capital gain made by a non-resident shareholder on the disposal of quoted Irish company shares is not liable to Capital Gains Tax in Ireland.

The tax leakage resulting from foreign investment in the Irish property market via exempt entities may be limited at present, but, to the extent that the introduction of a REIT structure increases foreign investment through its attractiveness to large institutional foreign investors, this may become a more significant issue in the future.

The introduction of an Irish REIT structure has been proposed by a number of interested parties including The REITS Forum, the NDFA, the NPRF, NAMA, Annaly Capital Management and Fitzwilliam Finance Partners. The proposals suggest that a REIT structure could encourage investment in Irish property and attract foreign investment capital to the sector. A REIT structure allowing for investment in foreign property could also allow for the development of Ireland as a management hub for international REIT property investment, which would be a significant new business platform for the IFSC.

4.6 Payments to Non-Treaty Jurisdictions

The Irish tax code allows beneficial treatment for certain cross-border transactions, contingent on the existence of a tax treaty with the relevant foreign jurisdiction.

A measure was introduced in Finance Act 2012 to allow a deduction to treasury companies for interest payments made to group companies in non-treaty countries, but only to the extent that the income is subject to tax upon receipt in the non-treaty jurisdiction. This was designed to ensure that the measure cannot be used to facilitate 'no country taxation' as it will only be effective where tax is paid in the recipient country and will not provide an effective outlet for domestic base erosion.

The industry have welcomed this approach, and have requested that consideration be given to widening its application.

5. Technical Issue:

5.1 Islamic Finance – requirement that investment certificates are "issued to the public".

The definition of "Investment Certificates" in s.267N TCA1997 contains a requirement that a certificate be "issued to the public". The public is defined as "individuals generally, companies generally or individuals and companies generally".

Concerns have been raised that this definition is vague, and that it may be difficult to issue a legal opinion as to whether a particular certificate has been "issued to the public". A public offer may also involve additional costs and administration, such as the publication of a prospectus for example.

It has been indicated that the promoters of Islamic Finance products would like the ability to issue such certificates to a relatively small number of high net worth individuals, and that they may issue certificates through multi-issuance vehicles, which may not fall clearly within the definition of "issued to the public".

It has therefore been proposed that the wording of s.267N be amended. If this proposal is to be considered it may also be appropriate to include certain anti-avoidance measures, such as a restriction on issuance to connected persons.

6. Other Issues

As mentioned in the introduction, it should be noted that in addition to the IFS-specific tax issues examined in more detail above, a number of common concerns were raised broadly across a number of industry groups:

i) The introduction of the Special Assignee Relief Programme (SARP) and the Foreign Earnings Deduction (FED) were both broadly welcomed as the attraction of key international talent is a priority issue for the IFS sector. However, the industry consensus is that the reliefs in their present form are not sufficient to attract the key high-level decision-makers necessary to stimulate new business and employment growth, and the above Groups have all stated that improvements to SARP and FED are high on their agendas, along with a number of other proposals relating to the taxation of non-domiciled individuals. These issues are being considered separately as part of broader income tax policy.

ii) xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx

The Tax Strategy Group may wish to consider the issues raised in this paper.