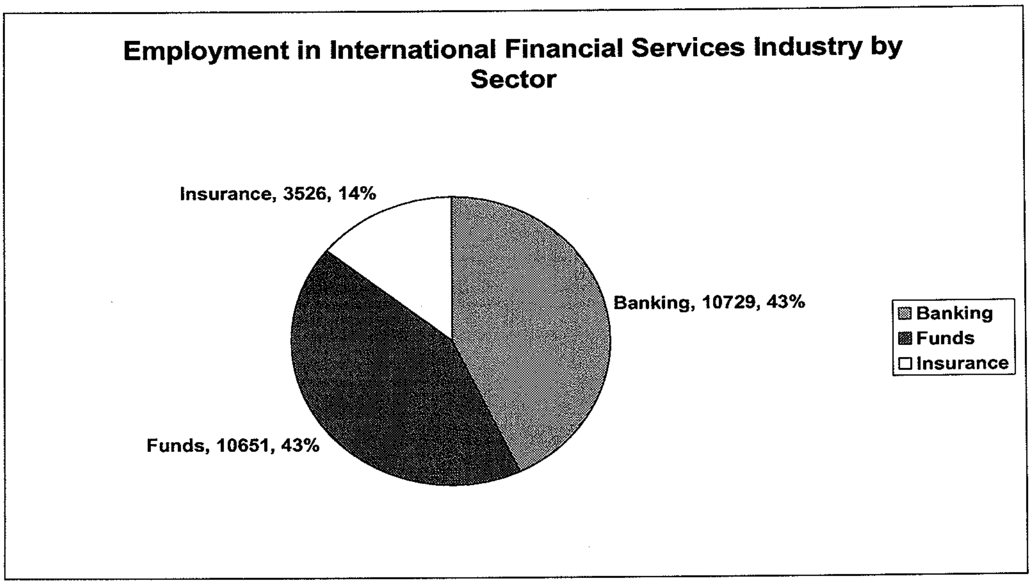
Tax Strategy Group
International Financial Services

1. Introduction

1.1. The international financial services sector broadly comprises the funds, banking and insurance industries. The breakdown, in terms of employment is illustrated below. There are approximately 25,000 people directly employed in the sector. When certain support services are taken into account the overall figure rises to just under 30,000.



1.2. The Revenue Commissioners estimate that the corporation tax yield from IFS companies was €850m in 2008 (back to 2005 levels - from €1.1bn in 2006 and €1bn in 2007).

1.3. The international financial services sector is represented on a number of groups established under the auspices of the Department of An Taoiseach, and at a high level on the Clearing House Group (CHG). The Department of Finance and the Revenue Commissioners engage with the industry through participation in the CHG process.

1.4. The Government's approach to the international financial services industry is based on the recommendations of two key reports, which set out a strategy for the future development of the International Financial Service industry in Ireland: *Building on Success* and the *Expert Group on Future Skills Needs Report on the International Financial Services Industry.*

1.5. The Government identifies the international financial services industry, in its *Smart Economy* strategy paper, as having the potential over the medium term to contribute significantly to the growth of output and employment in the Irish economy.

1.6. The CHG commenced a process early this year to increase engagement between the public and private sectors on the strategic direction of the International Financial Services Industry in Ireland. In this regard, a facilitated industry workshop was held in Dublin Castle in February of this year. A number of the proposals which emerged from that workshop have been implemented and a number of specific taxation measures are being considered in the context of the forthcoming Finance Bill.

2. Dublin Castle Process

2.1. As mentioned above, a number of tax issues of importance to industry were identified at the Dublin Castle workshop. Several of these issues have already been addressed by the Revenue Commissioners through administrative changes.

2.2 A further group of proposals are not being considered due to cost or reputation concerns.

2.3 In addition to the Dublin Castle proposals, we have received submissions from the following groups in the context of Budget and Finance Bill 2010:

- *CHG Banking and Treasury Working Group Tax Sub-Group*
- *CHG Insurance Working Group Fiscal and Accounting Sub-Group*
- *CHG Funds Working Group Tax Sub-Group*
- *CHG Banking and Treasury Working Group International Asset Finance Sub-Group*
- *The Irish Securitisation Forum*
- *The Department of Enterprise, Trade and Employment*

2.4 Because all of the CHG Working Groups were represented at Dublin Castle in February, there is significant overlap between their specific pre-Budget submissions and the items already identified under the Dublin Castle process. It is intended to focus this paper on the following key items:

- *Cash-pooling*
- *Section 80A – Operating Leasing*
- *Taxation of Foreign Dividends*
- *Unilateral Relief for Royalties*
- *Property Funds*
- *Non-Resident Declarations*
- *Foreign Branch Credits*
- *Shariah Finance*

3 *Cash-pooling*

3.1. Cash pooling is a treasury management function where a multinational company seeks to centralise all its deposits and overdrafts on a daily basis in order to minimise costs and maximise returns. Difficulties arise where members of a company group are located in jurisdictions with which Ireland does not have a tax treaty as withholding taxes are applied and deductibility of interest payments disallowed when interest payments are made to such jurisdictions. The banking and treasury industry insist that cash-pooling is a growth area and opportunities exist for Ireland in terms of increased profits from this business and in terms of employment. We are seeking more detailed information on this aspect and it is proposed to engage further with industry on this issue.

4. *Section 80A – taxing operating lessors on the profits returned in their financial statements*

4.1 Cross-border leasing of short-life assets is a significant industry that initially became established under the IFSC regime. The availability of 100% capital allowances in Year 1, combined with our strong reputation in the related aircraft leasing field, encouraged a number of large multinationals to use Ireland as a base for their small-ticket leasing operations. A recent industry survey estimates that there are currently 435 people directly employed in the sector.

4.2 Section 80A for finance leases was introduced in Finance Act 2004 against a backdrop of concern that the industry may be adversely affected by the ending of the IFSC regime and the switch to an 8-year write-down period on assets. It is worth noting that the measure was not sought in respect of operating lessors at that time. In the interim, however, the use of operating leases has been increasing for a variety of reasons.

4.3 Industry estimate that there are roughly 50,000 people employed in the short life leasing business worldwide. Even 1% of worldwide jobs would mean 800 additional jobs here and additional corporate and personal tax revenue of €217 million per annum.

4.4 Industry anticipates that the lessors currently based in Ireland could increase their front line work force by approx. 200 as a direct result of the proposed amendments to S80A (plus an additional 133 indirect jobs).

4.5 There is no doubt that the industry proposal has some merit and would address inequities in the tax treatment of operating lessors, as against finance lessors. However, there are two issues that would also need to be considered before making a decision – 1) cash-flow costs to the exchequer and 2) containment issues.

4.6 In relation to the potential cash-flow costs, consideration is being given to whether such costs could be limited by inclusion of a specific transition measure in the amending legislation.

4.7 Regarding containment, this change could increase pressure for other changes to the capital allowances regime. However, a separate treatment already exists in respect of finance leases. Extending that treatment to operating lessors would remove the current anomaly and would be confined to the leasing sector....

5 ***Taxation of Foreign Dividends***

5.1 The Group will recall that a number of changes have been made to the tax code over the last few years to make Ireland attractive as a location for holding companies.

5.2 Industry continually makes submissions requesting that Ireland introduce full participation exemption[1] in respect of foreign dividends.

5.3 Under current legislation, dividends paid out of the profits of foreign subsidiaries of Irish companies are taxed when they are received in the State. The Irish tax due on these dividends is reduced by any withholding tax suffered and by any foreign tax paid by the foreign subsidiary on the profits out of which the dividend is paid (underlying tax). Dividends received by a company which are paid out of the trading profits of a non-resident company that is resident in an EU Member State or in a country with which Ireland has a tax treaty are charged to tax at the 12½% rate of corporation tax. Where a dividend is paid out of both trading and non-trading profits the portion of the dividend referable to trading profits is taxed at 12½% with the balance taxable at 25%.

5.4 Dividends paid by a company resident in a non-treaty country are in all cases treated as paid out of non-trading profits whether paid directly or indirectly to the resident company. Limiting the application of the 12½% rate to trading profits from treaty countries was intended to give assurance to our treaty partners that the provision could not be used to facilitate conduit companies, i.e. companies in Ireland through which dividends might be routed before being distributed to countries affording participation exemption to treaty partner countries.

5.5 In the case of most non-treaty countries there is no equivalent system to the "exchange of information" articles in treaties. However, section 21B of the TCA provides that the 12½% rate applies to dividends to the extent that the claimant can *prove* that the dividends are paid out of trading profits. This places the onus on the company to obtain the information necessary to support its claim. If the provision were to be extended to dividends sourced from

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[1] Participation exemption is a general term relating to an exemption from taxation for a shareholder in a company on dividends received, and potential capital gains arising on the sale of shares.

trading profits of non-treaty countries, additional assurance could be provided as respects non-treaty countries by requiring that the company be directly or indirectly controlled by a quoted company.

5.6 One option to consider is whether the 12½% rate should be extended to take account of the underlying trading profits of (a) all treaty-resident companies and (b) other companies owned directly or indirectly by a quoted company.

5.7 This option should enhance our attractiveness to multinationals considering relocating to Ireland. There are significant potential benefits in terms of additional business activity and tax yields. It is likely that a holding company may bring with it other back office activities such as headquarter facilities, shared service centres, treasury functions and research and development facilities. In moving its holding company to Ireland, a multinational which already has operations here would become more embedded in Ireland thus increasing the possibility of future investment being located here also. A multinational with no previous connections with Ireland would, on moving its head office to Ireland, become comfortable operating here; increasing the possibility that Ireland would be on the agenda when locations for other investments by the multinational are being considered. While there is unlikely to be any Exchequer cost following the introduction of this measure, any subsequent foreign direct investment on foot of the change could, of course, yield additional tax revenue for the Exchequer as well as increased employment.

5.8 In addition, currently, dividends paid for a period are apportioned so as to determine the amount of the dividend that is to be treated as paid out of trading profits. In the context of multinational groups that hold trading companies through tiers of holding companies, it has been argued that this requirement may limit the ability to obtain the 12.5% rate of tax on dividends that ultimately come from trading subsidiaries. It has been proposed that consideration be given to removing the requirement to apportion in the case of dividends that are specified as paid out of trading profits.

6. <u>Unilateral Credit Relief for Royalties</u>

6.1 Three main types of income suffer foreign tax: dividends, interest and royalties. Relief for foreign tax is given either as a credit against the tax on the Irish measure of that income, or by reducing the income chargeable to tax by the foreign tax. The former method is the most beneficial to the taxpayer.

6.2 Where such income is received from a treaty country, credit relief is available for any related foreign tax against Irish corporation tax on that income. Unilateral credit relief is available in respect of foreign taxes on dividends and on interest which is taxed as trading income.

6.3 Relief from foreign withholding taxes on royalties is a key issue for software and other companies which have royalty flows from the country where their product is sold or licensed. Withholding tax is applied to many royalty payments and can impose a much greater burden than corporate tax as it is imposed on turnover rather than profits. Countries typically impose withholding taxes of between 10 and 30 percent on royalties and these rates are generally reduced under tax treaties.

6.4 Credit against Irish corporation tax is available in respect of tax suffered on royalty income from treaty countries.

6.5 In addition, companies currently entitled to manufacturing relief are also entitled to unilateral credit relief under s449 TCA 1997 in respect of withholding taxes on such income from non-treaty countries. However, this entitlement will cease on 31 December 2010 as part of the ending of the 10% Corporate Tax Manufacturing regime. The question of extending unilateral credit relief once the manufacturing relief regime ceases has been raised.

6.6 Companies outside the scope of manufacturing relief receiving foreign royalties which are subject to withholding taxes in non-treaty countries are currently only entitled to reduce the Irish measure of the foreign income by the foreign withholding tax. There are a number of such companies. It has been suggested that, for equity and EU requirements, unilateral credit relief be extended to such companies also. The combined exchequer cost of the two measures is estimated at circa €6.5m.

7. ***<u>Extend the Section 110 definition of qualifying assets to include property</u>***

7.1 The Irish funds industry is making renewed efforts to attract fund promoters to domicile their international property funds in Ireland.

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7.3 Industry have also requested that the definition of qualifying assets for the purposes of Section 110 of the TCA be extended to include property. This would enable Irish domiciled international property funds to manage their underlying foreign taxes exposure in a tax efficient manner, thus increasing their competitiveness.

7.4 The Section 110 provisions currently only allow for the holding of financial assets. Extending the provisions to allow for the holding of property would represent a significant broadening of the current provisions. In addition, other groups, for example the leasing industry, have previously requested that the provisions be broadened to allow for the holding of physical assets.

7.5 Given that different groups are requesting different changes to the current system, it is considered that consultation with the broader financial services industry is required before making a decision on this proposal.

8. ***Non-resident declarations for foreign investors in Irish domiciled investment funds***

8.1 An Investment Undertaking (IU) operating in Ireland is required to deduct exit tax -

- when making a payment to a unit holder in respect of an actual disposal of units;

and/or

- on the occurrence of an eight year chargeable event - which event is deemed to have taken place on the eight anniversary of the acquisition of the units and every subsequent eight anniversary;

unless the IU is in possession of a policyholder declaration to the effect that the person is not resident or ordinarily in Ireland for tax purposes.

8.2 As the vast majority of Irish domiciled funds are distributed solely to non Irish residents, it has been suggested that the current requirements present a disproportionate administrative burden on industry. In addition, existing procedures under the European Anti-Money Laundering legislation already highlight any investor holding an Irish passport or address.

8.4 Following discussions with the industry, the Finance Act 2008 granted Irish life assurance companies a waiver, on a freedom of services basis, to sell their policies directly from Ireland into other EEA states without having to obtain a non resident declaration from each policy holder. This was done on the basis that, by definition all their policyholders had to be foreign since they cannot accept policyholders with an Irish address.

8.5 It has been proposed, therefore, that we should examine the possibility of allowing a similar exemption from completion of non-resident declarations for foreign investors in Irish domiciled funds that are not marketed within this jurisdiction.

9. ***Introduction of a carry-forward provision for foreign tax credit pooling in respect of foreign branches.***

9.1 An Irish resident company with branches outside the State is generally taxable on the profits of the foreign branches with a credit available for foreign taxes suffered on the branch profits. The introduction of a unilateral form of foreign tax credit relief for taxes paid by foreign branches which are not located in jurisdictions with which Ireland has a double tax treaty, together with the introduction of a pooling system for such credits, in 2007 enhanced the attractiveness of Ireland for certain types of business, especially banking and insurance companies.

9.2 The pooling system operates such that, where the foreign tax paid on branch profits in a particular jurisdiction exceeds the Irish tax payable in any year (e.g. because the foreign effective tax rate is higher), any excess credits thus created can now be "pooled" and credited against Irish tax on branch profits in lower tax jurisdictions.

9.3 Similar provisions exist in respect of taxation of foreign dividends – including a provision allowing excess pooled credits which are not used in a particular year to be carried forward to the next period. It has been proposed that we consider extending this carry-forward provision to foreign tax credit pooling in respect of foreign branches in order to remove the current bias in the tax system which unintentionally favours the use of subsidiaries over branches.

10. Shariah/Islamic Finance

10.1 Shariah compliant finance is considered to be the fastest growing sector of finance in the world, growing at roughly 10% per annum. In 2007 the global Islamic financial market was estimated to be worth about $700bn. Approximately one quarter of the world's population is Muslim, yet according to recent evidence less than 1% of global financial assets are Shariah compliant. However, Shariah compliant products are not limited to Muslims but are available to everybody. It has been forecast by Standard & Poor's that the industry could potentially have assets totalling $4 trillion under control.

10.2 The Government has highlighted the Gulf Region as an area of growth for Irish businesses and investors. The Region is also home to large numbers of Sovereign Wealth Funds and large Regional Banks with access to significant investment capital. Ireland has recently concluded four Double Taxation Agreements with Gulf States (Saudi Arabia, Bahrain, Kuwait and UAE) – and significant opportunities for investment are potentially available provided the necessary tax changes are in place for Shariah compliant financial products. It has been suggested that providing for Shariah compliant finance would enable Ireland to compete for a share of this investment, in a space occupied by our major financial services competitors (Luxembourg, Netherlands, UK).

10.3 Shariah compliant finance (sometimes referred to as Islamic Finance) requires all transactions to comply with Shariah principles (Shariah is the body of Islamic religious law). The principles that Shariah compliant finance must observe include a prohibition on earning interest (riba), on uncertainty/speculation (gharar) and investment in 'unethical' businesses, products or services (such as alcohol, tobacco, pork, gambling, adult entertainment, weapons and conventional banks and insurance companies). Shariah compliant products are backed by an identifiable and tangible underlying asset, it is also important that the investor and investee share the risk of all financial transactions. Under Shariah law money is used to measure value and is not an asset in itself.

10.4 There are about 30,000 Muslims living in Ireland. Those who wish to use sharia-compliant finance cannot obtain such a mortgage in Ireland. The Muslim community in Ireland, through the Islamic Cultural Centre of Ireland and the Immigrant Council of Ireland, as well as through initiatives with individual lenders, has indicated a desire for Sharia-compliant finance.

10.5 In providing for Shariah compliant finance in Ireland it would be essential that it is introduced on a level playing field with existing financial products. To this end it would be necessary to make amendments to tax treatment of Interest, VAT, Stamp Duty, Capital Gains, Income Tax, and Consumer Credit legislation. There would be consequential amendments required to Irish GAAP reporting. It would also require clarifications from the Financial Regulator and the Revenue Commissioner's through statements of practice.

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

Appendix

Technical Items also being considered for Finance Bill 2010

1. ***Section 847, TCA 1997***
   Section 847 provides for exemption from corporate tax in respect of foreign branch income and from capital gains for foreign branch gains for a company which creates substantial employment in Ireland as a result of a substantial investment of permanent capital in the State. The company must apply directly to the Minister for Finance in order to avail of the provisions. Only a small number of companies ever availed of the exemption. The provision expires at the end of 2010 and it is necessary to legislate for some transitional provisions.

2. ***Section 402, TCA 1997***
   In January this year, the Minister agreed to amend Section 402 to cater for aircraft leasing companies taxable under Case IV (non-trading) rather than Case I. The section deals with the computation of losses and capital allowances where the functional currency of the company is not the euro. Revenue agreed to deal with cases on an administrative basis pending the legislative amendment.

3. ***Malta Double Taxation Agreement***
   Amendment to the DTA with Malta in relation to refundable tax credits.

4. **Section 590, TCA 1997**
   Section 110 companies are generally close companies so they come within the scope of the close company surcharge provisions and the anti- avoidance provisions of Section 590. A proposal has been received seeking that these sections be disapplied in the case of securitisation companies.

5. ***Section 81, TCA 1997***
   Section 81 may need to be amended to ensure that financial institutions cannot take an interest deduction in respect of Tier 1 interest.

6. ***Certification process for exemption from dividend withholding tax***
   Streamlining of the certification procedures for obtaining exemption from dividend withholding tax is being considered.

7. ***Section 1035A, TCA, 1997***
   The definitions used in Section 1035A require updating to take account of the impact of the EU Market in Financial Instruments Directive (MIFID).