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Tax Strategy Group

Corporation Tax – Domestic issues

Introduction

1. This paper deals with domestic issues relating to Corporation Tax (CT), international taxation issues and the IFSC are covered in separate papers. After setting out the background and recent trends in the CT yield, the paper details the main changes to the CT regime in recent years:

    - R&D tax credit scheme
    - Preliminary tax payment arrangements
    - Accelerated capital allowances for energy-efficient equipment
    - Tax exemption for new start-up companies
    - Tax relief for the acquisition of intangible assets

2. After discussing the implications of the recommendations contained in the Commission on Taxation's Report for Corporation Tax, a number of other CT issues are highlighted.

Background

3. In line with a Government Decision of May 1997, the standard rate of Corporation Tax was reduced on a gradual basis from 38% in 1997 to a rate of 12.5% on trading profits from 1 January 2003. Passive income and income from certain 'excepted' trades (e.g. mining and trading in development land) are taxed at a higher rate of 25% as are company Capital Gains.

4. The importance of the 12.5% rate was recognised in *An Agreed Programme for Government 2007- 2012*: "We recognise the vital role played by low taxes in our economic success. We guarantee that the 12.5% rate of corporation tax will remain". This Programme also stated that the Government would "Keep Ireland's Corporation Tax at its current level at most and veto any EU proposal which might undermine this", while it would "Press for a single all-island corporation tax of 12.5%".

5. In recent Budgets, the Minister for Finance has highlighted the importance of the rate and that it would remain unchanged. The Budget 2009 speech stressed that "the 12.5% rate was an important element in our taxation system and a cornerstone of our industrial development in the last decade", while also highlighting that "the rate is not for changing upwards and that it will continue to be a central part of Ireland's economic brand". In the Supplementary Budget speech of last April, the Minister indicated that: "we will retain our 12.5% rate as a key aspect of our inward investment strategy".

6. The recently negotiated Renewed Programme for Government echoed the sentiments of the earlier Programme: "We recognise the vital role played by low taxes in our economic success. We guarantee that the 12.5% rate of corporation tax will remain".

7. The tax yields from Corporation Tax from 2002 to 2008 are set out below.

Year	Yield €m	Proportion of total tax yield
2002	4,083	16.4%
2003	5,161	16.1%
2004	5,332	15.0%
2005	5,492	14.0%
2006	6,683	14.7%
2007	6,391	13.5%
2008	5,066	12.4%

Main changes to the broad Corporation Tax regime in recent years

8. The main changes affecting the corporation tax regime in recent years have involved:
   - the introduction of an R&D tax credit in 2004, which has been enhanced over subsequent years;
   - increases in the Corporation Tax liability threshold for treatment as a 'small company' for preliminary tax payment purposes and the introduction of two preliminary tax payment dates for 'large companies';
   - accelerated capital allowances for companies for the purchase of specified energy-efficient equipment;
   - a tax exemption scheme for new start-up companies commencing to trade in 2009; and
   - a scheme of capital allowances for the provision of intangible assets.

R&D tax credit scheme

9. Budget/Finance Act 2004 introduced a 20% tax credit for companies on qualifying incremental expenditure on research and development (R&D) as compared with R&D in a base year (2003). The tax credit is available for set-off against a company's CT liability in the current year with the unused balance available for carry-forward against future years' tax liability until the credit(s) are fully utilised. The 2003 base year was originally to apply for a period of three years (until 2006) before rolling on to 2004 in order to measure incremental R&D expenditure arising in 2007. Under the scheme as initially introduced, it was envisaged that the base year would move forward each year thereafter (e.g. for calculating the 2008 credit, the base year would move to R&D expenditure in 2005 et seq.). Instead, the use of 2003 as the base year was extended in subsequent Budgets and Finance Acts and other changes were introduced which also significantly enhanced the scheme. The significant changes involved:
   - Permanently setting 2003 as the base year under the scheme so that over time the scheme will, in effect, become volume-based;
   - Increasing the rate of tax credit from 20% to 25% of incremental R&D expenditure;
   - Allowing the carry-back of unused tax credits for set-off against a company's prior year CT liabilities thus generating a tax refund;

- Providing an option, where there is insufficient current or prior year CT liabilities, for a company to claim unused tax credits in cash over 3 years from the Revenue Commissioners; and
- Amending the scheme to allow a proportion of capital expenditure on buildings used for R&D purposes to qualify for a tax credit of 25% (previously expenditure on new or refurbished buildings would only qualify for the tax credit if used "wholly and exclusively" for R&D).

10. The R&D tax credit scheme has cost over €400 million in claims for tax relief over the period 2004 to 2007 (the latest year for which data is available). Given the length of time required for R&D activities to come to fruition, any significant benefit arising from the R&D tax credit scheme may only emerge in the medium to longer term. Most OECD countries have an R&D tax credit scheme in place to incentivise this activity and to attract foreign investment in this area. Ireland's scheme is currently among the most competitive and it remains under ongoing review to ensure that this position is maintained.

Preliminary tax payment arrangements

11. As part of the *quid pro quo* for the phased reduction in the standard Corporation Tax rate to 12.5%, the payment date for preliminary Corporation Tax was brought forward from six months after the end of a company's accounting period to one month before the end of the accounting period. This process was carried out over a phased transitional period from 2002 to 2006 and provided a cash-flow benefit to the Exchequer over this period.

12. Preliminary tax paid must amount to a minimum of 90% of the final CT liability for the current period otherwise an interest charge applies. At the time of the completion of the transitional arrangements for bringing forward the payment date for preliminary tax, a 'small company' with a final tax liability in its previous accounting period of €50,000 or less had the option of either paying preliminary tax of a minimum of 90% of its final liability for the current period or 100% of the final liability of the preceding period. The latter option provides certainty and avoids any interest charges.

13. Budgets 2007 and 2008 (and the consequent Finance Acts) increased the tax liability threshold for treatment as a 'small company' for preliminary tax payment purposes to €150,000 and €200,000 respectively, thus providing about 97% of companies in the State with the prior year option for paying preliminary tax. Only about 2,500 or so 'large companies' must continue to meet the minimum 90% of final liability for the current period in terms of preliminary tax payments. Extending the prior year option to all companies would involve a considerable cash-flow cost to the Exchequer.

14. In addition to the concessionary treatment of small companies, new or start-up companies with a CT liability of less than €200,000 in their first accounting period are not required to pay preliminary corporation tax in that first accounting period and are instead required to pay their full CT liability when submitting their tax returns (9 months after the end of the accounting period).

15. Budget 2009 and Finance (No. 2) Act 2008 further changed the preliminary tax payment arrangements for 'large companies' (i.e. where CT liability exceeds €200,000 in the previous accounting period). For accounting periods commencing after 14 October 2008, these companies are now required to pay their preliminary Corporation Tax in two instalments instead of one. The first instalment is payable in the six month of the accounting period. The amount payable must be 50% of final CT liability in the previous accounting period or 45% of CT liability for the current accounting period. The second instalment is payable, as under the previous arrangement, in the month before the end of the accounting period. The second instalment must bring total preliminary tax paid to 90% of the final CT liability for the current accounting period.

Accelerated capital allowances for energy-efficient equipment

16. Budget and Finance Act 2008 introduced a new scheme of accelerated capital allowances for expenditure by companies on certain energy efficient equipment in the following three technology categories: Motors and Drives; Lighting and Lighting Controls; and Building Energy Management Systems. The scheme was commenced in October 2008 and companies can claim 100% capital allowances on expenditure on specified eligible equipment in the year of purchase.

17. The scheme was extended to seven categories of technology in Finance (No. 2) Act 2008 to include:

    - Information and Communications Technology
    - Heating and Electricity Provision
    - Process and Heating, Ventilation and Air-Conditioning (HVAC) Control Systems
    - Electric and Alternative Fuel Vehicles

18. Expenditure must be above a certain minimum amount in order to qualify for the accelerated allowances. The energy-saving criteria to be met by each category of technology and the list of specified qualifying equipment are developed and maintained by Sustainable Energy Ireland. The updated criteria and list are published periodically by order of the Minister for Communications, Energy and Natural Resources. The scheme has been established to operate for a trial period of three years.

Tax exemption for new start-up companies

19. Budget 2009 and Finance (No. 2) Act 2008 introduced a measure providing that a new start-up company commencing to trade in 2009 will be exempt from Corporation Tax, including tax on capital gains, in each of its first three years to the extent that the tax liability of the company does not exceed €40,000 in those years.

20. The following are the main provisions of the scheme:

- The exemption will apply only to companies incorporated on, and from, 14th October 2008 that commence to carry on a new trade in 2009.
- The exemption period is three years from the date of commencement of the new trade.
- Exemption is granted in respect of the profits of a new trade and chargeable gains on the disposal of any assets used for the purposes of a trade.
- Exemption is granted by reducing the corporation tax relating to the trade and chargeable gains of the company to nil.
- Full relief will apply where the total corporation tax liability does not exceed €40,000 in any of the years of the three year period. Marginal relief will apply between €40,000 and €60,000 to ensure new start-up companies with a liability of just over €40,000 do not have to pay the full amount.
- A company taking over an existing trade or part of a trade, which was carried out in the State by another person, will not qualify in respect of income of the trade taken over.

21. The provisions introducing the scheme are subject to a commencement order pending the (imminent) conclusion of discussions with the EU Commission on the compatibility of the scheme with the requirements of the Commission's general *de minimis* aid Regulation

Tax relief for acquisition of intangible assets

22. The introduction of a scheme of tax relief for the acquisition of specified intangible assets was announced in April's 2009 Supplementary Budget and introduced in Finance Act 2009. This measure has been introduced to support the development of the knowledge economy and the provision of high quality employment. It was highlighted in the Government's economic recovery plan as a way to fill a gap in our supports for the smart economy and it complements other Government initiatives to promote Ireland as a location of choice for investment in R&D and innovation.

23. While our tax system already provided allowances for a limited range of intangibles (i.e. patent rights, computer software, know-how), we did not have a broad based scheme for intangible assets generally.

24. The significant features of the scheme include:

    - The availability of tax allowances for capital expenditure on the provision by companies, including acquisition, of a broad range of qualifying intangible assets for the purpose of a trade (companies must be trading to qualify for the relief).
    - The application of tax relief to the provision of intangible assets between connected (or Group) companies as well as to transactions between unconnected third parties.

- Transactions between connected parties must comply with “arm’s length” pricing requirements.
- The write-down period over which the writing down allowances is to apply is based on the accounting treatment of the assets and will thus vary from asset to asset. Companies can opt for a fixed write-down period of 15 years (7% allowances per annum and 2% in the final year). The option for a fixed write-down period also caters non-depreciating assets e.g. brands, which are not depreciated in the accounts.
- Where the relief by way of allowances and related interest deductions would otherwise be greater than 80% of the income of the trade, the relief will be restricted to 80% of that income, leaving a minimum of 20% of trading income within the charge to tax. The amount of any excess allowances and interest after applying this restriction will be carried forward for offset against income of the trade in succeeding accounting periods.
- Normal capital gains tax rules will apply on the subsequent *disposal* of intangible assets which qualified for relief under the scheme.
- Expenditure subject to relief under the R&D scheme or under any other provision (e.g. a deductible expense) will not qualify for allowances under the scheme.
- The scheme of wear and tear allowances for capital expenditure on the provision of computer software has been retained and computer software does not qualify under the new scheme for intangible assets. As patent rights and know-how are included in the new scheme, the existing schemes of allowances for capital expenditure incurred on patent rights and know-how are being discontinued, subject to transitional arrangements.

The Commission on Taxation Report recommendations on the CT regime

25. The Commission on Taxation Report recommends, as a general principle, the continuation of the existing 12.5% standard rate of CT as a core aspect of Irish tax policy “to support economic activity in the long term” (Recommendation 7.1).

26. The Report also contains a number of recommendations relating to the operation of the CT regime and some of the tax incentive schemes already dealt with in this note. These recommendations are set out in the following table:

Scheme/ Feature	Recommendation
Tax exemption for new start-up companies	Exemption should be extended to companies starting out in 2010 (for two years) and in 2011 (for one year). (Recommendation 7.6)
Preliminary tax payment arrangements	All companies should be allowed adopt the prior year option in relation to the payment of preliminary tax, having regard to the cash-flow costs involved to the Exchequer (Recommendations 7.11 and 7.12

R&D tax credit scheme	Companies should, at their option, be permitted to offset their R&D tax credit against their employer PRSI costs (Recommendation 7.20)

27. The Commission's Report includes a number of recommendations relating to other aspects of the CT regime. The most significant of these are dealt with in the following paragraphs.

28. Recommendation 7.10 states that the **capital gains** of companies from the disposal of trading assets (presumably plant and machinery and buildings, etc) should be taxed at the standard rate of 12.5% instead of at an (effective) Capital Gains Tax rate of 25% as is currently the case. The purpose of this treatment is to allow companies invest more in their businesses and to equalise the tax treatment of earnings from trading and gains from asset disposals. Implementation of this recommendation would cost an estimated €75 million. The Report does not consider the implications of a move in this direction for the CGT treatment of property assets based on land, generally, or of the claims for equal treatment by sole traders or non-corporates in regard to the tax treatment of their asset disposals.

29. The Commission recommends the removal of the **close company surcharge on professional service companies** (recommendation 7.13). Broadly, a close company is a company under the control of 5 or fewer participators (including associates), or of participators who are directors. Most Irish owned companies are close companies. Section 441 TCA 1997 provides that closely held companies engaged in the provision of professional services are subject to a surcharge of 15% on 50% of trading profits which are not distributed within 18 months of the relevant accounting period. The legislation does not define professional services, but they include those provided by accountants, architects, auctioneers, doctors, dentists, vets, engineers, journalists, management consultants and solicitors. In 2007, some 791 companies paid €6m in surcharges under section 441.

30. The purpose of the close company surcharge on professional income is to prevent avoidance of personal income taxation through the accumulation of income within a corporate structure. With company profits from professional services subject to the 12.5% rate of Corporation Tax, there would be a strong incentive, in the absence of a surcharge, for persons engaged in professional activities or employments to earn and accumulate their income within a company and thereby avoid income tax at the higher 41% rate (plus levies).

31. The Commission Report acknowledges that the differential in Income Tax and Corporate Tax rates (which was 27% in 1976 when the surcharge was introduced) remains an issue. Nevertheless, it points out that the surcharge results in an effective CT rate of 19% on undistributed professional income (as opposed to 12.5% for trading income) and it recommends abolition of the surcharge on equity and pro-business grounds.

32. Recommendation 7.14 of the Report states that the **surcharge on investment and estate income of close companies** should be retained. However, it considered that the *de minimis* amount before the provisions come into play should be substantially increased in order to ease the regulatory burden for companies in such cases. Section 440 TCA 1997 provides for a surcharge of 20% on any investment and rental income of a close company which is not distributed within 18 months of the end of the accounting period in which that income was earned. In 2007, some 4,400 companies paid a total of €19m in surcharges under section 440. The purpose of the surcharge is to prevent avoidance of personal income taxation through the accumulation of passive non-trading income within a corporate structure.

33. While the Commission considers that the surcharge should be retained, it has recommended a significant increase in the €635 exemption limit to ease the regulatory burden on SMEs in operating the surcharge provisions. The Report does not specify what the increased limit should be.

34. Recommendation 7.18 suggests broadly that taxable income of a business should be based on the accounting profits of a business with normal statutory disallowances and that, in particular, **accounts depreciation of capital assets should replace the capital allowances regime**. The recommendation arises from the view that the tax system should be responsive to the realities of modern business. Current expenditure is deductible as a business expense for tax purposes where it is wholly and exclusively incurred for the purpose of the trade. Capital expenditure is not deductible for tax purposes and, instead, such expenditure on industrial buildings, plant and machinery and motor vehicles may qualify for capital allowances at various rates over various periods. A more restrictive write-down arrangements for the cost of capital assets (resulting in a broader tax base for CT purposes) has historically been part of the price to be paid for a low standard rate of CT.

Other issues for consideration

35. There are two other issues in the CT area which are worthy of some mention. These are transfer pricing legislation and the tax treatment of trading losses.

36. **Transfer pricing** describes the process by which associated companies set the price for transactions conducted between them. The ability to influence prices between related parties also provides an opportunity to influence the profits earned by each party to the transaction and consequently the tax payable in each jurisdiction. Much of international trade involves transactions between associated companies and to prevent abuse in these situations, the OECD has set the arms-length principle as the standard for setting transfer prices. This principle asserts that intra-group transfer prices should be equivalent to those that would be charged between independent persons dealing at arm's length in otherwise similar circumstances. In practice, the detailed application of the arm's length principle is based on extensive guidance provided in the OECD Transfer Pricing guidelines. The idea is that each party to a transaction should be rewarded for the additional value it has generated (assessed in terms of functions performed, assets used and risks assumed) on the basis that this is how

dealings between independent persons would be compensated. Thus, in a cross-border situation, each jurisdiction receives the tax due on the value generated by the commercial activity undertaken within its jurisdiction. Most OECD countries have enacted legislation based on these OECD Transfer Pricing Guidelines.

37. Apart from limited transfer pricing rules in relation to profits chargeable at the 10% rate of tax, Ireland does not have general transfer pricing legislation. The introduction of legislation has been considered in the past, but not advanced for a variety of reasons. However, an initial assessment suggests there are advantages to the introduction of legislation in this area. Specifically, it is considered that legislation in this area could:

- Bring Ireland into the mainstream in that all EU Member States and most OECD member states have transfer pricing legislation;
- Help to prevent the use of conduit companies for tax avoidance;
- Protect against erosion of the Irish tax base;
- Enhance Ireland's capacity to influence the direction of future developments in transfer pricing; and
- Defend the integrity of our 12.5% regime where harmful tax competition is explicitly linked to abusive transfer pricing.

38. Ireland provides tax relief for **trading losses** incurred by companies which is a standard feature of CT regimes in all OECD countries. The provisions allow for the carry-back of such losses in an accounting period for offset against profits of the immediately preceding accounting period (thus generating a tax refund). A three year carry-back of losses applies in the case of a termination of trade. There is also provision for the use of losses by other Group companies in the accounting period in which they arise and for indefinite carry-forward of losses by a company for offset against income of the same trade arising in future accounting periods.

39. The tax treatment of trading losses is of longstanding and it is justified on the basis that companies should be in a position to recover losses incurred in the normal course of trade. XXXXXXXXXXXXXXXXXXXXXXXXX XXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

40. The Tax Strategy Group may wish to discuss.

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