Tax Strategy Group
International Financial Services

1. Introduction

1.1. The international financial services sector continues to make a major contribution to the Irish economy in terms of employment and corporation tax yield. Recent Finance Dublin figures suggest that employment in the international financial services sector now stands in excess of 19,000. When certain support services are taken into account this figure rises to over 23,000. The corporation tax yield from the sector totalled €823.5 million in 2005.

1.2. The funds sector, employing over 8,000 persons is the most significant employer with a net asset value by end June 2005 of over €500 billion. On the Banking side some 8,000 are also employed and the latest estimates indicate that total assets stand at just under €350 billion. Insurance sector employment stands at just under 3,000 with a total gross written premiums value coming in at just over €18 billion – a figure that puts the Irish market on a par with the Lloyds' insurance market. The Securitisation sector has also preformed strongly with Irish investment in Asset Backed Securities of up to €100 million.

1.3. This continued strong growth of the sector is particularly impressive given, as the Group will be aware, the ending of the special tax measures for IFSC companies on 1st January, 2006 and the successful migration of these companies to the general 12 ½ % corporation tax regime. Assisting this transition were a range of measures introduced in last year's Budget and Finance Act aimed at maintaining the momentum achieved by the sector in a post-IFSC era. Notable amongst these were the abolition of Companies Capital Duty (CCD) and changes made to the operation of the leasing ring-fence to facilitate big-ticket leasing – a sector in which Ireland is emerging as a world leader. XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX..

1.4. The Tax Strategy Group will recall that 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). At the request of Industry, the CHG undertook in 2006 to reformulate a strategy for the future of the financial services industry based on input from Industry itself, relevant Government Departments, the Revenue Commissioners, the Financial Regulator and the IDA. The Department of Finance actively engaged in this process through participation in the CHG process and through commenting and observing on the input from each of the groups in which we participate. This exercise led to Government approval for the publication of the document, "Building on Success", and it was launched by An Taoiseach in September 2006.

1.5. Building on Success sets out a framework for the development of the international financial services sector in Ireland. Apart from the legislative and fiscal areas for which the Department of Finance and the Revenue Commissioners have provided input, the document covers the areas of Regulation, Market Expertise, Skills Education and Training, Product Development and Research & Development. It identifies several essential conditions for success, such as infrastructure, cost competitiveness, Government support and partnership, coupled with policy consistency as it relates to the international financial services sector. The members of the Clearing House Group provided input relevant to their particular sectors.

1.6. The document reflects any concerns expressed by this Department in relation to the scope of fiscal and legislative changes recommended in it and the feasibility and desirability of such changes. It also notes the measures introduced in last year's Budget and Finance Act, and restates concerns that Government has about artificial structures. In relation to specific fiscal issues, the document refers to the ongoing consideration of a number of medium term issues that have been identified as requiring attention such as further developments for the Securitisation industry, as well as on-going policy response to new product development.

2. Budget & Finance Bill 2007 Submissions focussing on this sector

In the context of Budget and Finance Bill 2007, we are considering submissions from;

- *Financial Services Ireland*
- *The Irish Securitisation Forum*
- *The Irish Bankers Federation (IBF/FIBI)*
- *The Institute of Taxation*

There is a good deal of crossover between the various submissions in particular those from FSI and IBF/FIBI. It is intended to focus only on substantial individual issues raised in the submissions rather than technical points or points of clarification.

2.1. FSI/IFS Tax Group

2.1.1. In keeping with the established process, Industry, through FSI has identified measures that it believes need to be addressed in order to enhance the competitiveness of the financial services sector in Ireland, and increase Ireland's attractiveness as a centre for International Financial Services operations. A number of changes have been sought and these are currently being examined mainly in the context of the Finance Bill. Some of the priority policy items identified by Industry were also contained in the pre-budget submission of the IBF/FIBI. The relevant issues identified are;

- Participation exemption for dividends
- Extension of double taxation relief to branch structures
- Interest re-characterised as a distribution
- Tier 1 interest*
- Interest withholding tax*
- VAT on rating agency fees to Securitisation Special Purpose Vehicles (SPVs)

2.1.2. Whilst none of these issues are new, those flagged with an asterisk above, have been raised before in the context of previous discussions and decisions have been made not to change

current policy. Moreover, some of these same issues have been addressed in the discussions on Building on Success where no different conclusions were reached. In the case of the VAT issue, this is the subject of ongoing discussions between Revenue and Industry. It is intended to focus this paper on those key items that merit further consideration.

2.1.3. *Participation Exemption for Dividends*

2.1.3.1.The Group will recall that the Holding Company measure, introduced in Finance Act 2004, provides for a capital gains tax exemption on the disposal of a foreign subsidiary by an Irish holding company. Industry, through the FSI submission and through direct representations from industry principals, has requested that a similar exemption be introduced for dividend payments from foreign subsidiaries to an Irish holding company.XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXX

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2.1.4. *Extension of Double Taxation Relief Pooling to Branch Structures*

2.1.4.1. This is an issue that originally came to light in the context of discussions on the Participation Exemption as outlined above. Under current tax law, a foreign tax credit can only be obtained for foreign tax paid against the Irish tax due, on the same item of income which has suffered the foreign tax. There is no ability to offset any excess credit against any other class of foreign or domestic income.

2.1.4.2. An exception to these rules is in the case where dividends are received from subsidiaries and substantial shareholdings where *special* credit relief rules apply. Furthermore, Finance Act 2006 provided for the pooling of foreign tax paid on interest to Irish companies from subsidiaries in EU or treaty countries.

2.1.4.3. These exceptions are limited to dividend and interest payments from subsidiary companies of an Irish parent company. Industry has requested that any excess foreign tax credits which arise in relation to branch trading income of an Irish company should be allowed to be offset against Irish tax arising on other income (including other branch income) of the Irish company.

2.1.4.4. We are currently examining this proposal.

2.1.5. *Interest re-characterised as a distribution*

2.1.5.1. This issue is linked to the discussions that have taken place in the past in relation to interest withholding tax in the context of the ending of the IFSC regime on 1 January, 2006. It is also connected to the concerns raised about Ireland's Tax Treaty network.

2.1.5.2. Under tax law, interest which is paid to a 75% related non-resident company is treated as a distribution and is disallowed for tax purposes such as deducibility, by virtue of Section 130 TCA 1997. Companies however may elect, by virtue of Section 452(2) TCA 1997, to not have this treatment apply where certain conditions are met and where the interest is to be paid to an EU or treaty county. Prior to 1 January 2006, IFSC and Shannon companies who met the other conditions could opt not to have the Section 130 treatment apply, regardless of the location of the recipient of the interest.

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2.2. **Irish Securitisation Forum**

2.2.1. Securitisation involves the creation of tradable securities out of existing assets or future income streams (loans and other types of receivables). It is used to raise finance in a manner more efficient than traditional borrowing. It is one of the fastest growing areas of the international financial services sector in Ireland. Following consultations between this Department, industry representatives and the Revenue Commissioners, Finance Act 2003 introduced significant changes to the tax treatment of Securitisation.

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2.2.4. In line with the strategy for the international financial services sector ‘Building on Success’, we are currently considering these issues with a view to identifying possible solutions in the context of this year’s Bill. This process is ongoing and involves detailed technical consultations with various parties from the industry.

2.3. <u>Irish Bankers Federation</u>

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2.4. Institute of Taxation

2.4.1. *Double Taxation Agreement Network*

2.4.1.1. The pre-budget submission of the ITI was almost entirely given over to discussion of Ireland's tax treaty network. The submission pushed as a key priority in the medium term the substantial expansion of our tax treaty network.

2.4.1.2. As a short term measure pending extension of the network, the ITI has called for the establishment of a "white list" of countries to allow for the fast-tracking of treaty negotiations and to allow for early application of some benefits in domestic legislation to those particular jurisdictions. It has also recommended the extension of certain benefits available under the treaties where the ultimate parent of an investee country subsidiary or an intermediary country subsidiary is in an EU or treaty jurisdiction.

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2.4.1.4. The Group may wish to note that the Irish double taxation agreement network continues to be expanded and updated and will number 45 when Chile completes its ratification procedures. Subject also to parliamentary procedures, it is expected that the protocol to the treaty with Portugal will become effective for tax periods in 2007.

2.4.1.5. New treaties with Argentina, Egypt, Kuwait, Malta, Morocco, Tunisia, Turkey, Ukraine and Vietnam are being negotiated. Negotiations have also taken place with Singapore but some matters remain to be agreed. Existing treaties with Cyprus, France, Italy and Korea are in the process of re-negotiation. New agreements with Greece and Iceland, which were signed in 2003, became effective for tax periods in 2005. A new

treaty between Ireland and Canada entered into force on 12 April 2005. The revised agreement applies from 1 January 2006.

2.4.1.6. The expectation is that progress in this area will exceed the medium term targets suggested in the ITI submission. The continued expansion of our network is a priority issue.

3. Other Issues

3.1. *Real Estate Investment Trusts*

3.1.1. As part of our ongoing commitment to be open to ongoing product development and innovation, both in general and in the context of the strategy 'Building on Success', we are examining the possible implications of providing for the tax treatment of Real Estate Investment Trusts (REITs).

3.1.2. A REIT is a tax designation for a corporation investing in real estate that reduces or eliminates corporate income taxes. The REIT structure was designed to provide a similar structure for investment in real estate as mutual funds provide for investment in stocks. It is a security that sells like a stock on the major exchanges and invests in real estate directly, either through properties or mortgages. REITs have existed in the US for about forty years and there is REITs legislation in Australia and Japan. The concept also appears to be gaining some momentum in Europe. The Netherlands has a REIT system and the UK and Germany are both in the process of introducing same. The issue is also being examined in the OECD where it would appear there is movement to address this on a more global basis.

3.1.3. By way of an example of how a REIT would operate, the UK model will broadly allow REITs to benefit from a tax exemption in relation to profits from a qualifying property letting business and an exemption for qualifying chargeable gains. Distributions from the REITs tax exempt business will then be taxed in the shareholders' hands as if they had received property income (and there will be a withholding mechanism for distributions from the tax exempt business) eliminating one level of taxation and shifting the burden of taxation from the company to the investor. There are conditions which need to be met for REIT status to apply.

3.1.4. The current position in the UK is that legislation was passed in this year's Finance Act (2006), and that HM Revenue and Customs are currently consulting on secondary legislation and guidance, to be released later this year. Companies will be able to convert to UK-REIT status from 1 January 2007. We have been monitoring these developments and have made good contact with the relevant officials.

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