TSG 10/19

Review of Pooling of Foreign Tax Credits on Royalty Income

I INTRODUCTION

1. This review largely stems from recommendation 7.22 in the 2009 Report of the Commission on Taxation, namely that '*An overall foreign pooling system for foreign withholding tax on royalty payments should be introduced*'. A number of submissions have also been made in recent years by various parties, such as Forfás and the American Chamber of Commerce, to introduce changes to the tax treatment of inbound royalty payments.

<u>Terms of Reference</u>

2 The terms of reference for the review are set out below:

(i) Investigate the validity of the 2006 €46.5m Forfás costing of a move to a pooling system for foreign tax credits on inbound royalties

- i.e. what's included/excluded from the €46.5m costing; impact on different sectors; impact of any relevant changes since 2006 - e.g. IP regime

(ii) Costs / Benefits of Potential Options for Introducing a Pooling System

- cost of introducing a single pool system versus 2 pools (treaty and non-treaty) etc.,
- cost, and determination of optimum level, of a limiting measure that would restrict the percentage of the unrelieved foreign credits that could be pooled
- identify, insofar as is possible, likely future behavioural changes which would impact on the cost XXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXX
- analysis of potential revenue / job benefits of a move to a pooling system

<u>Methodology</u>

3. Meetings were held with relevant officials in the following organisations with a view to obtaining data/information and to ascertain their views on the recommendation by the Commission on Taxation:

- Department of Finance,
- Department of Enterprise, Trade and Employment,
- Enterprise Ireland,
- Forfás,
- IDA,
- Revenue Commissioners.

4. A data collection exercise was carried out by the Revenue Commissioners at the end of March 2010. They circulated their districts/units with a request for information regarding royalties received from abroad in 2008. On foot of this, a detailed analysis of the 2008 tax returns of XXXXXXXXXXXXXXXXXX in Ireland was conducted.

5. A meeting was also held with the CSO to see if relevant data could be obtained from them. In addition, meetings were also held with the following accountancy practitioners to listen to their views on the impact of withholding taxes on royalties on their clients.

    - PwC
    - KPMG.

6. The review also briefly restates relevant Forfás research which outlines the arguments in favour of introducing pooling, provides a costing for a new pooling scheme and describes pooling schemes in other countries where pooling is available.

7. The structure of this paper is outlined as follows:

    - Section II briefly outlines the current tax treatment of royalties payable to Irish businesses in respect of Intellectual Property (IP) that is used abroad.

    - Section III compares the treatment of royalties in Ireland to the treatment of royalties by selected jurisdictions.

    - Section IV considers the basis of the Forfás costing by assessing the assumptions underlying the model and estimating a range of costs for the scheme.

    - Section V considers the Costs / Benefits of Potential Options for introducing a Pooling System.

II CURRENT TAX TREATMENT OF FOREIGN ROYALTY INCOME

<u>Double Taxation</u>

8. Double taxation can arise where a person who is resident in the State has income arising in another country. The income may be taxed in that other country because it is sourced there. It will also be taxable in the State as part of the person's worldwide income.

9. Double Taxation Agreements (DTAs or treaties) are designed to prevent double taxation. They do this by allocating the right to tax particular sources of income between the two countries concerned. This might involve one of the countries having the sole right to tax income. An alternative approach is that both of the countries would be entitled to tax the income but tax paid in the source country of the income would be credited against the tax payable on that income in the other country. Many countries adopt this latter approach in relation to royalty

payments. In addition to preventing double taxation, withholding tax rates are typically reduced under double taxation agreements.

10. Three main types of income suffer foreign tax; dividends, interest and royalties. 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 relief is available in respect of foreign taxes on dividends, interest and royalties (since Finance Act 2010) which are taxed as trading income.

Income from treaty countries – double taxation relief

11. 'The credit method' **-** Irish tax legislation provides a credit for any foreign withholding taxes imposed by a country with which Ireland has negotiated a tax treaty. A credit is provided for the lower of the foreign withholding tax or the Irish tax arising on the same income. The current rules for calculating foreign tax credits for foreign tax suffered on income from territories with which Ireland has a double tax treaty are set out in schedule 24 of the Taxes Consolidation Act 1997. The rules limit the foreign tax credit to the Irish tax attributable to the foreign source income – the limit is calculated as 12.5% of the 'Irish measure of the foreign income'.

Example:

Country A

Sales in Country A	€1000
Withholding tax rate	10%
Withholding tax in Country A	€100
Profit margin in Country A	30%
Net Profit in Country A	€300
Irish tax in Country A	€37.50

12. Under the current system, if Company X receives royalties of €1,000 from Country A, Country A imposes a withholding tax of 10% or €100. If Company X's net profit margin is 30% then Company X earns €300.
Relief in respect of the foreign tax is granted as follows;

Irish income before deduction for foreign tax		300
Deduction for foreign tax		72
Taxable amount		228 @12.5%
Corporation tax		28
Credit for foreign tax	28	
Net Liability	Nil	

Credit for the €100 foreign tax has been given as follows; €72 by deduction and €28 by way of credit.

Income from non-treaty countries – unilateral relief

13. Where Ireland does not have a tax treaty in place, relief can still be given unilaterally under Irish law. This involves giving credit for tax suffered in the source country against Irish tax on the income concerned in spite of the fact that there is no reciprocal arrangement.

14. Finance Act 2010 extended unilateral relief to include royalty income (trading income only) from all countries. (Prior to Finance Act 2010, unilateral relief was available generally in respect of dividend and interest income but, in the case of royalty income, it was limited to companies availing of the 10% Corporate Tax Manufacturing regime[1]. This regime expires at the end of 2010.) The legislation classifies royalties as payments in respect of

- copyright of literary, artistic or scientific work, (this includes cinematograph films and software);
- patents, trade marks, designs or models, plans, secret formulae or processes, or
- information concerning industrial, commercial or scientific experience.

15. Royalties are payments for the use of intellectual property (IP). XXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXX

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Issues arising in relation to foreign royalty income

18. A significant number XXXXXXXXXXXX operating in the State receive income by way of foreign royalties XXXXXXXXXXXXXXXXXXXXXXXXXXXXX Withholding tax is charged by the foreign jurisdiction on the gross payment (turnover) while the income charged to Irish tax is after expenses (profit) which in most cases are significant – XXXXXXXXXXXXXXXXXXXXXXXXX Even in the cases of royalties from treaty countries where withholding tax rates are relatively low, the foreign tax may exceed the Irish tax on the income – in the example above, a significant portion of foreign tax remains ‘unrelieved’.

19. Currently, the foreign withholding tax suffered on royalty income from a particular country can only be offset against the Irish corporation tax attributable to the income from that country. The Commission on Taxation proposal is seeking that we allow unrelieved foreign tax from one country to be offset against Irish corporation tax attributable to royalty income from another country. This is known as ‘pooling’.

Pooling

[1] Section 449 TCA 1997

20. The Taxes Acts currently provides for pooling on a restricted basis in respect of foreign tax on both dividends and interest. Pooling is available in respect of foreign tax on dividends received from a company's foreign subsidiaries (minimum holding 5%) and in respect of interest (taxed as trading income) received from a company's foreign 25% subsidiaries resident in treaty countries.

Differences between pooling for Dividends and Interest

21. However, there are significant differences between the pooling provided for dividends and branch profits on the one hand and interest on the other.

(i) Dividends -

- all dividends qualify whether from treaty or non-treaty associated companies
- the associate holding requirement is 5%, and
- there is carry-forward of any surplus credits that cannot be pooled in the current year.

(ii) Branch profit pooling is on a similarly comprehensive basis.

(iii) There is a more restrictive regime for interest—

- the interest must be from treaty associated companies
- the associate holding requirement is 25%, and
- there is no carry-forward of surplus credits.

22. Part of the explanation for the different approaches outlined above is that dividends are not deductible in computing the source-country profits and therefore are paid out of *taxed* profits whereas interest, being generally deductible in the source country, will not have been taxed indirectly in the way dividends are.

23. However, both dividends and interest may suffer foreign tax directly by the deduction of withholding tax and, in addition, pooling in both cases involves a forgoing of Irish tax.

III INTERNATIONAL COMPARISON

Investment decision

24. The tax paid on royalty income is one of the many factors which could influence a company’s choice to locate to or remain in Ireland. Other factors would include cost competitiveness, availability of a skilled labour force, the rate of corporate taxation and the level of infrastructure. It is not possible to quantify the relative importance of the tax treatment of royalties in investment decisions made by multinational companies. However, recent economic developments have encouraged companies to restructure their businesses in order to minimise withholding taxes particularly where tax on royalties constitutes a significant expense. In addition, companies are also considering the consolidation of activities into regional hubs. As a result, competition for investment in this area is likely to intensify.

Comparison of tax treatment

25. From the perspective of international investors, there are a number of factors which improve the attractiveness of a country in terms of its tax treatment of royalty income:

- The number of double taxation treaties negotiated with important destination markets
- The level of foreign withholding tax rates agreed in these treaties
- The definition of royalty income provided for in these treaties and the interpretation of the application of withholding tax to royalty income
- The availability of pooling

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27 There are a number of important competitor countries XXXXXXXXXXX which offer more attractive treatment of royalty income through an increased number of double taxation treaties, more favourable foreign withholding tax rates for key export destinations and pooling of royalty income. As against this, Ireland's corporate tax rate is lower than many countries and additional incentives for intellectual property and R&D have been introduced in recent years. XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

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XXXXXXXXXXXXXXXX At this stage, the ability to carry forward unused credits is not common to pooling systems although the ability to pool royalty income in a single pool is a feature in the countries where pooling is available.

IV COST OF INTRODUCING POOLING SYSTEM

30. There are two cost elements to a pooling scheme - the static cost and the dynamic behavioural cost. The static cost is the cost of the scheme based on the current circumstances of eligible beneficiaries for the scheme e.g. foreign royalty income, corporation tax on royalty income etc. As described above, the current Irish tax treatment allows some relief for foreign withholding taxes paid but a portion of foreign withholding tax goes 'unrelieved'. The static cost is the amount of this currently 'unrelieved tax' that could be offset against corporation tax if pooling was introduced.

31. The dynamic behavioural cost takes into account the additional costs which could accrue if companies changed behaviour as a result of the scheme XXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

32. There are a number of cost drivers for the scheme. Taken on an individual company basis, the tax forgone per beneficiary is based on:

    - the distribution of foreign royalty income between different jurisdictions with varying rates of withholding tax
    - the net margin on foreign royalty income subject to Irish corporation tax
    - the Irish corporation tax liability on all royalty income eligible to be relieved through foreign withholding tax credits.

<u>Forfás Model</u>

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34. As per the terms of reference, the Forfás costing has been examined by reviewing the model's assumptions and by cross-checking with available Revenue information. Since the detail of the calculations and the underlying company data were not available, it was not possible to conclusively test the validity of the model. For example, it is not clear how the unrelieved foreign tax on royalty income was established. Nor is it not known if / how the Irish tax attributable to royalty income from treaty countries was estimated for each given company. (If pooling was introduced, foreign tax on income from one jurisdiction could be offset against Irish tax payable on royalty income from another jurisdiction. In order to establish how much of the foreign tax could be relieved upon the introduction of pooling, it is necessary to establish how much Irish tax is payable on royalty income from the other jurisdictions in the pool).

35. However, conclusions were reached regarding the main assumptions of the model. These are set out in the table below.

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37. In order to assess the accuracy of Forfás' analysis, a review was carried out of all XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX, to determine the number of XXXXXX companies with turnover above XX XXXXX. Based on a cursory examination, it was considered that XX XXXXXX on the Irish Times list XXXXXXXXXX with turnover above XXX. XXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

38. The key issue here is whether or not the companies concerned have royalty income but it is not possible to identify that fact without looking at the tax computation of each individual company. XXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

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39. The most recent available tax computations XXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXX were examined. XXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX Thus, the loss of revenue to the State XXXXXXXXXXXXXXX would be €132 million if pooling, with no restrictions, was introduced. XXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXX

40. We estimate that the cost would increase to approximately €150 million when extended XXXXXXXXXXXXXXXXXXXXXXXXXXX suffering withholding tax. The table below gives a more detailed breakdown of costing. XXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXX

40. The extent to which unrelieved tax corresponds to tax forgone under pooling depends on the Irish tax on royalty income available for relief. XXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

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<u>Risk of Behavioural Change</u>

41. In addition to the static cost of introducing a pooling system, any new measure could lead to behavioural changes which could influence the annual cost of the scheme. XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXX This could result in a potentially very significant loss to the exchequer.

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43. It could be argued that this static cost is entirely a deadweight cost as the companies concerned currently operate here in the absence of pooling. However, Forfás strongly argue that this additional tax incentive is necessary to maintain existing business and to improve Ireland's tax offering as a destination for the location and exploitation of intellectual property. The case made by Forfás is outlined below.

44. There are a number of possible options that would allow us to limit the considerable static costs identified above and to mitigate the upside risk presented by a change in behaviour.

V THE CASE FOR CHANGE

45. Historically withholding tax was often considered a cost of doing business in a particular country and appeared as a cost of sales in the accounts. In recent years, accounting standards have confirmed that withholding tax should be shown as a tax and therefore shown on the tax line of financial statements. This has highlighted the cost of withholding tax in recent years.

46XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXX. Companies are increasingly consolidating their activities into regional headquarters XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXX

47. Global sourcing has created new forms of competition that are changing the shape of markets and introducing new players to compete on price, quality and speed. Companies are increasingly seeking to consolidate all of their key, high-value activities into one location. XXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXXXXXXXXXX

48. Given the growing importance of IP and recent efforts to attract IP to Ireland, the tax treatment of its income flows (royalties) may become more important in the future as a factor for companies making FDI decisions.

49. The expiry of the 10% tax regime at end-2010 and the potential for additional tax receipts arising from the transition of some of the largest companies to the 12.5% rate means that this may be the opportune time for considering this issue.

Summary of Benefits / Pros XXXXXXXXXXX

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- General direction of "new business" transactions is likely to be in the "knowledge" rather than "goods" space, therefore our tax systems needs to acknowledge this direction.
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The Group may wish to consider the issues raised in this paper.

<u>Appendix I</u>

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