Tax Strategy Group
Corporation Tax

Section 1 : Context

1.1 Introduction

This paper sets out recent trends in the yield from CT and deals with the background to and importance of maintaining our single low rate of CT on trading income. The paper sets out the main developments in the CT regime in recent years and discusses the potential for further change in these areas to facilitate economic growth.

1.2 Trends in Yield from Corporation Tax

Ireland's low corporate tax rate does not discriminate based on company size or ownership. It features a low tax rate applied to a broad base. For these reasons, despite the low rate (although no longer the lowest in the EU), corporate tax revenue in Ireland is similar to other EU countries. Corporate tax revenue in Ireland in 2009 was equal to 2.5% of GDP and the average for the EU as a whole was 2.7%.[1]

The yield from corporation tax has been falling in recent years, from €6.7 billion in 2006 to €3.9 billion in 2010.

The tax yields from corporation tax from 2003 to 2010 are set out below.

Year	**Yield €m**	**Proportion of total tax yield**
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	12.3%
2009	3,900	11.7%
2010	3,940	12.4%

Exchequer receipts from corporation tax dropped by close to 40% in the period between 2007 and 2009. In the same period nominal GDP fell by 15% and nominal GNP by 19%. While both the CT numbers and the GDP/GNP figures take into account the deflation that occurred in the economy at the time, it is striking that the fall in CT receipts outpaced the fall in the value of economic output, indicating that the fall in corporate profits over the period significantly exceeded the overall fall in value of economic activity.

1 *Taxation Trends in the European Union*, 2011 Edition, Eurostat.

1.3 Background to and Importance of Maintaining the 12.5% CT rate

Ireland is geographically and historically a peripheral country in Europe. A low corporate tax rate is a tool to address the economic limitations that come with being a peripheral country as compared to core countries.

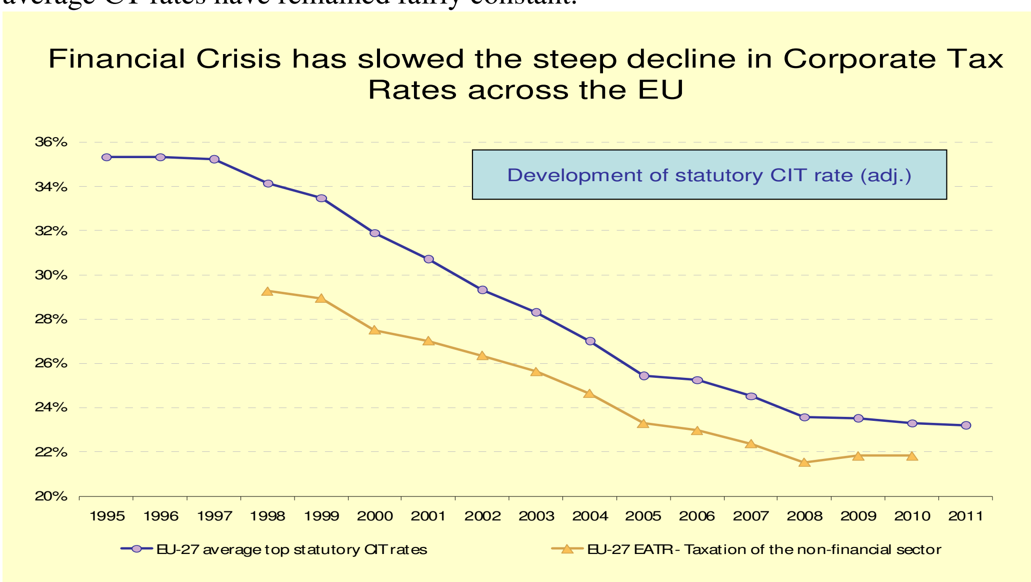
Ireland's low corporation tax regime has its origins in the export profits tax relief (EPTR) measures introduced by the second inter-party government in 1956[2].

Ireland has now had a competitive tax offering as part of its overall inward investment strategy for decades (EPTR since the 1950s and later the 10% IFSC / manufacturing rate). The standard corporate tax rate (applying to the domestic and non-manufacturing sectors) was as high as 50% in 1986 and 40% in 1995. A general 12.5% corporate tax rate has applied from 1 January 2003 to all trading profits with a 25% rate applying to all non-trading income, such as investment income.[3] The 10% rate for manufacturing activities ceased to apply after 31 December 2010.

The corporation tax rate remains a key policy tool today. Our single 12.5% rate on trading profits has become akin to a brand associated with Ireland; its simplicity is part of the attraction which IDA and others market abroad.

A recent ESRI report[4] commenting on the impact of the lowering of the CT rate stated that "the change in the corporate tax regime is estimated to have added around 3.7% to the level of GNP by 2005."

The graph[5] below illustrates the steep decline in CT rates in Europe in the last decade. Both statutory and effective average rates (EATR) are shown here. Since 2008 average CT rates have remained fairly constant.



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2 *Foreign Investment and the Politics of Export Profits Tax Relief 1956*, Frank Barry, TCD, 2011

3 A 25% rate also applies on excepted trades (certain dealings in land, income from working minerals and petroleum activities).

4 *The macro-economic impact of changing the rate of corporation tax,* Thomas Conefrey, John D. Fitz Gerald, 17 November 2010

5 Taxation trends in the European Union, 2011 edition, Eurostat

Given Ireland's strong and long-standing commitment to the 12.5% rate, any movement away from this rate would have a significant negative signalling effect on investment.

The Department of Finance is routinely asked to give reassurances to new and existing FDI clients about the stability of and policy intent around corporation tax and the 12.5% rate in particular. It seems clear that any changes to the corporation tax rate could negatively impact on the future stream of investment and job creation by foreign direct investors. FDI pipeline projects remain strong.

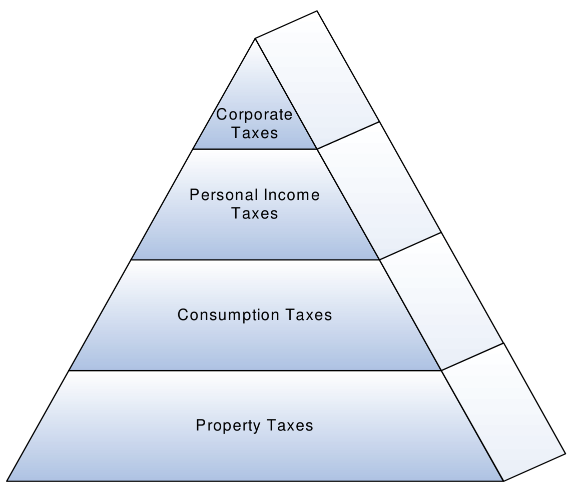
The overall strategy for inward investment of low taxes, a business friendly environment and a well educated workforce remains as valid today as it did 50 years ago.

Indeed, the recent Commission on Taxation recommended that "*a low stable corporation tax rate should remain a core aspect of Irish tax policy to support economic activity in the long term"*.

Research by the OECD points to the importance of low corporate tax rates to encourage growth.[6] In ranking taxes by their impact on economic growth, corporation tax was found to be most harmful. In other words, governments seeking additional tax revenues would be advised to consider increasing all other types of tax (property, consumption and income) before increasing corporate taxes.

<u>OECD "Hierarchy" of Taxes</u>

Most Harmful



Least Harmful

Any increase in Ireland's corporation tax rate would generally not be expected to translate into a redistribution of overseas investment to other EU Member States but would instead drive a redistribution of economic activity to competitor blocks such as the Far East or Switzerland. A loss of investment in Ireland would therefore tend to be a loss of investment in Europe.

[6] OECD 2008, *Tax and Economic Growth,* Economics Department Working Paper

Section 2 : Competitive CT issues

2.1 R&D Tax Credit Scheme

Budget and Finance Act 2004 introduced a 20% tax credit for companies on qualifying additional or incremental expenditure on research and development (R&D) as compared with R&D expenditure in a base year (2003). The tax credit was originally 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 is fully utilised.

The R&D tax credit scheme has been enhanced in most Budgets and Finance Acts since its introduction. A recent independent study by Mazars[7] on the cost of global R&D initiatives after tax and other cost incentives has placed Ireland among the world's most competitive locations in this regard.

Tax credits available as cash refunds are particularly attractive to start-up companies or SMEs which are not making profits as the credit can effectively part-fund the R&D activity and acts as a valuable source of cash-flow.

Key features of the scheme include:

- A tax credit of 25% on incremental R&D expenditure – in addition to the normal 12.5% trading deduction
- The base-year has been permanently set at 2003, making it effectively volume based for new entrants
- There is no ceiling to the level of eligible expenditure over the 2003 base year
- Unused tax credits can be carried back for set-off against a company's prior year CT liabilities thus generating a tax refund
- Where there is insufficient current or prior year CT liabilities, the company can claim unused tax credits in cash over three years
- Expenditure includes direct and indirect costs in addition to capital expenditure on related plant and machinery
- A proportion of capital expenditure on buildings used for R&D purposes now qualifies 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)

<u>Cost of scheme to date</u>

The cost of the scheme including value of tax credit claimed, administration costs and compliance costs comes to more than €800m for the period 2004 to 2009. The majority of costs relate to the value of claims which has risen from €82m in 2004 to approximately €215m in 2009[8]. There have been almost 3,000 claims from 2004 to 2009.

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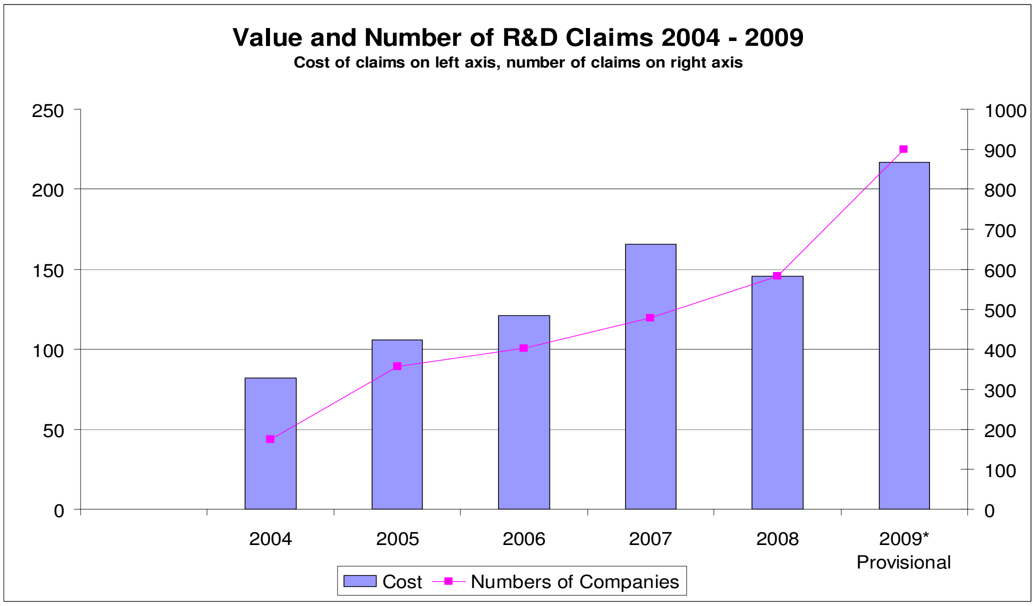
[7] *Review of Global R&D Tax Incentives,* July 2010

[8] The cost for 2009 includes the amount of credit allowed against 2009 tax together with the amount offset against tax of previous accounting periods and as payable credit. This information was not available for earlier years.



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.

Programme for Government

The Government for National Recovery 2011-2016 contains a commitment to carry out a cost benefit analysis on the following aspects of the R&D scheme :

- *Companies with R&D spend <€100k to get R&D tax credit on the full amount*

This is likely to be a small cost on its own but breaches the incremental nature of the credit and could lead to bigger costs down the line. It is also likely to come up as a deadweight (with strong incentives to post-hoc analysis by advisers) and may not fare well in a CBA.

It is important to note that since the base year is not indexed to inflation, firms that maintain their R&D expenditure at 2003 levels in real terms actually spend more than the base level in nominal terms and therefore benefit from the credit due to an inflationary effect.

Preliminary analysis has been carried out on the costs of introducing a volume basis for companies with R&D spend of less than €100k.

There is a limit to the data available on how many of these companies there may be – information on the amount of base year expenditure was requested for the first time by firms that applied for a credit in 2009. The 2009 CT1 form was the first time that information was sought on R&D expenditure in the 2003 base year for all claimants seeking a tax credit. Ninety companies provided data on 2003 base year expenditure. It should be noted that this is not the full population of firms that engaged in R&D in 2003 and does not capture the following:

- Firms that engaged in R&D in 2003 that are no longer trading
- Firms that engaged in R&D in 2003 and did not engage in R&D in 2009

- Firms whose 2009 R&D expenditure was less than 2003 R&D expenditure and were not eligible for a credit in 2009
- Firms that were engaged in R&D in 2003 and 2009 and are not aware of the R&D tax credit regime
- Firms with low expenditure who made no claim due to possible costs involved

From this data we know that total eligible R&D expenditure in 2003 amounted to €77.3m. These firms currently receive a credit on expenditure above this base level. 34 of the 90 reference firms had R&D expenditure in 2003 of less than €100,000 – this group collectively had qualifying expenditure in that year of €1.2m.

If the first €100,000 of all current year expenditure of <u>all</u> firms (not just those with expenditure less than €100,000) was subject to a volume based credit, with anything above this threshold subject to an incremental credit, this would cost approximately €2.25m, based on the limited CT1 data. Again, this is likely to be an underestimate of cost for the reasons listed above, namely that the full population of firms that engaged in R&D in 2003 were not captured in the 2009 Revenue data.

- *Companies to be allowed offset R&D tax credit against employers PRSI as an alternative to CT.*

As part of the Jobs Initiative, the R&D tax credit scheme was amended in Finance (No2) Act 2011 to increase the payroll liabilities limit from the aggregate of those liabilities payable in one accounting period to the aggregate over two accounting periods, thus increasing the quantum of the tax credit that can be accounted for above-the-line for those companies who choose to do so and for whom the payroll liabilities limit is considered to be a limiting factor. This effectively meets the commitment.

- *To cut down on red tape, companies in receipt of RTI grant will be automatically deemed as entitled to R&D tax credit*

This item raises issues of granting automatic tax entitlements on foot of unrelated grant aid. This and the special regime below €100k may give rise to EU state aid concerns. The issue of avoiding harmful state aid in an EU context is an important factor to consider. EU jurisdictions are therefore at a potential disadvantage when competing with non-EU jurisdictions. However, there may be opportunities to simplify the system without giving rise to such issues.

<u>Further possible enhancements</u>
While Ireland's R&D tax regime is well understood by larger scale enterprises with significant in-house R&D resources, take up among smaller companies continues to be low.

The following possible options would seek to improve the attractiveness of Ireland's R&D tax regime for SMEs in particular but would have general application so as to avoid state aid issues. The suggested limits would limit the overall cost of these enhancements.

- At present sub-contracted costs are eligible where they do not exceed 10% of total costs – 5% in the case of sub-contracting to third level institutions. This limit can disproportionately affect smaller companies who may have greater need to outsource R&D work than larger multinationals with greater internal resources. The outsourcing limit could be increased but set at a maximum monetary amount say, the *greater* of 5/10% or €100k. This would provide a targeted benefit to SMEs.

- Allow companies in receipt of the R&D credit the option to use a portion of the credit to reward key employees who have been involved in the development of R&D. This would in effect be a "tax free" bonus but could be limited so that a minimum effective tax rate of 30% is paid by the employee.

  There would be no additional cost to the Exchequer as the transferred tax credit comes from the R&D credit already received by the company and the employee still pays the full tax liability on their other income.

<u>Example</u>
An employee's gross remuneration is €115,000, the net is €66,334 with a tax take of €48,666 giving an effective tax rate for the individual of 42.3%

Under this proposal €14,166 can be paid to the employee by the company as an effective bonus.

2.2 Tax Relief for Acquisition of Intangible Assets

R&D tax incentives form only a part of an overall tax regime that promotes innovation and growth. In addition to the tax treatment of R&D related expenditure, other key features include the tax treatment of income from the exploitation of R&D derived assets.

A scheme of tax relief for the acquisition of specified intangible assets was announced in the 2009 Supplementary Budget and introduced in Finance Act 2009. This measure was introduced to support the development of the knowledge economy and the provision of high quality employment. It complements other initiatives to promote Ireland as a location of choice for investment in R&D and innovation.

The scheme provides for the availability of capital allowances on a flexible basis for capital expenditure on a broad range of specified intangible assets used for the purpose of a trade, including non-depreciating assets such as brands.

The main features of the scheme include:

- The availability of tax allowances for capital expenditure on the provision by companies, including acquisition, of specified intangible assets.
- 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 for non-depreciating assets eg brands, which are not depreciated in the accounts.
- 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 and these pricing arrangements may be questioned by Revenue (and by tax authorities in other jurisdictions) from a transfer pricing perspective to ensure that profits arising from intangible asset activities here are commensurate with the level of activities taking place here.
- Qualifying intangible assets must be recognised as such under generally accepted accounting practice and the scheme will apply to specified assets, as defined.
- There will be no claw-back of the allowances where the intangible assets are disposed of more than 10 years after they were brought into use in the trade.
- A number of restrictions apply to ensure that the scheme operates effectively. These restrictions include the treatment of activities related to qualifying intangible assets as a separate trade and writing down allowances will only be available for set-off against the income of that separate trade. Any related interest expenses will also only be available for set-off against income of the separate trade.
- Where the relief by way of allowances 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 allowances affected by this restriction will be carried forward for offset against income of the trade in succeeding accounting periods.
- Expenditure subject to relief under the R&D scheme or under any other provision (eg a deductible expense) will not qualify for allowances under the scheme.
- Gains on the disposal in Ireland of intangible assets qualifying for allowances will come within a charge to tax.

2.3 Patent / Innovation Boxes

Countries such as the Netherlands and Switzerland have introduced so-called 'patent box' regimes which offer a low preferential rate of tax on certain patent income. The income generated by patents is 'boxed off' from other trading income and subjected to a preferential rate of tax (eg by disregarding a significant proportion of patent income). The UK is planning to introduce a similar regime in 2013 which will provide a preferential 10% tax rate for patent income.

However, it is important to bear the following in mind when making comparisons with competitors in this area:

- Countries that have introduced patent box regimes have corporation tax rates which are significantly higher than our 12.5% rate
- Ireland has introduced a tax relief scheme for IP (intellectual property) which is expenditure-based, with relief in the form of capital allowances. Companies availing of the scheme can achieve a significantly reduced cash tax rate on profits arising from IP exploitation
- Introducing an income-based scheme that provides a low preferential rate for IP income may be seen by our EU partners as aggressive in the context of a 12.5% corporation tax rate and it could provoke a negative response. xxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx

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A difficulty with patent box schemes is that they may not be entirely effective in promoting R&D, as the incentive targets the income which results from patented technology rather than the research itself. Also, under European law it is not possible to restrict such a measure to patented technologies in a specific EU country.

The patent royalty exemption was abolished in Finance Act 2011 on foot of a recommendation from the Commission on Taxation which concluded that the tax exemption had not resulted to any great extent in companies carrying out additional R&D activity and that it provided a windfall gain after a successful invention was developed rather than an incentive to undertake new R&D.

The total cost to the Exchequer of the patent income exemption was €72 million in 2009, of which approximately €16 million was associated with claims from companies.

UK Patent Box

The UK authorities have produced a number of consultation documents on the proposed introduction of a patent box. In a consultation document on Corporate Tax Reform published in November 2010, they expressed concern that some patent-rich UK businesses face higher overall effective tax rates than their foreign competitors, which benefit from special regimes available in other countries. In that document they state that while the UK Government does not feel it necessary to match these regimes, it does recognise that there is a need to improve the competitiveness of the UK corporation tax regime to complement the non-tax advantages of the UK as a leading location for R&D and intellectual property.

The UK Patent Box appears to be targeted mainly at UK companies with patents or the ability to develop patents as opposed to mobile intangible assets from other jurisdictions.

There may be a number of changes to the proposals between now and the expected implementation date of 1 April 2013.

It is expected that draft legislation will be published in autumn 2011 with a view to being enacted in the UK Finance Bill 2012.

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The British government estimates that administrative costs related to the patent box will be between £2 million and £5 million.

2.4 Corporate Losses – Impact on CT Yield

Ireland provides tax relief for trading losses incurred by companies which is a standard feature of CT regimes in all OECD countries. Losses in one accounting period can be carried back for offset against profits of the immediately preceding accounting period, generating a tax refund. A three year carry-back of losses incurred in the last 12 months of trading applies in the case of a termination of trade. Losses can be carried forward indefinitely for offset against income of the same trade arising in future accounting periods. Group companies can use losses in the accounting period in which they arise.

The economic environment in which Irish businesses currently operate mean that a large number of companies are not generating enough profits for a tax liability to arise. This is reflected in the CT yield which has been falling in recent years and may not recover for some time to come.

Corporate losses have increased significantly in all OECD countries as a result of the economic crisis. In Ireland, the biggest losses have been incurred in the banking, construction and property-related sectors. The significant increase in corporate losses will have an impact on CT receipts in the years ahead but it is not possible to estimate the full extent of this, as the use of loss relief will depend on the capacity of companies with accumulated losses to generate sufficient profits to absorb such losses. This will vary from sector to sector and it is likely that some companies will not be able to utilise much of their losses because of insufficient profits or the cessation of their business. While the domestic banking sector (now largely loss-making) was in the past a major contributor to corporation tax, a very significant proportion of CT yield continues to come from a relatively small number of consistently profitable companies, mainly multinationals - the yield from these companies will be unaffected by losses.

Apart from affecting corporation tax yield, the significant increase in corporate losses arising from the recent financial and economic crisis poses tax compliance risks which will need to be monitored. While there are various restrictions under existing legislation to counter the transfer of losses from one company to another, it will be necessary to remain vigilant to any aggressive tax planning schemes that may emerge which seek to circumvent existing restrictions on the use of losses.

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Provisions already exist in the case of banking institutions participating in the NAMA process under which only 50% of such institutions' taxable trading income in any year can be sheltered by losses carried forward by those institutions. There are, however, very particular circumstances applying in the case of the NAMA-participating banks.

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2.5 Participation Exemption & Controlled Foreign Company rules

An Irish resident company is subject to tax on its worldwide income and capital gains with credit relief given for taxes paid in respect of foreign income and capital gains.

An Irish resident company is generally exempt from Irish corporation tax on dividends received from another Irish resident company. Foreign dividends are subject to corporation tax in Ireland with credit relief generally available for taxes withheld on the payment of the dividends and taxes paid on profits from which the dividends were paid.

Ireland also offers a corporation tax exemption from capital gains on gains arising on the disposal of substantial shareholdings in circumstances where the Irish parented group is engaged in trading activities and the subsidiary is resident in an EU Member State or a tax treaty country.

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Controlled Foreign Company rules

The main purpose of CFC rules is to prevent resident companies avoiding domestic tax by diverting income to subsidiaries in lower tax countries. The parent company is taxed on profits earned by foreign subsidiaries which have not been repatriated to it either in the form of dividends or capital gains. Income of an amount equal to the relevant profits of the foreign subsidiary is deemed to arise directly to the parent company which is then subject to tax on that amount at the tax rate applicable in the country of residence of the parent company.

CFC provisions typically apply to foreign subsidiaries in which the investor has a controlling interest (although the holding can be 10% or lower).

2.6 Foreign Branch Exemption

Currently, the availability of a credit for foreign tax on branch profits means that in most cases there is no additional Irish tax due on foreign branch profits as the foreign tax rate is generally higher than the Irish tax at 12.5% rate. Also foreign branch losses can be set against Irish head office profits. This latter point is particularly useful in the start-up phase of venturing overseas.

Some countries, such as Germany and the Netherlands provide for foreign branch exemption through their treaties. This is not a short or medium term option for Ireland.

The UK is planning to introduce an opt-in foreign branch exemption system which is likely to take effect in 2012 and which potentially places the UK at a competitive advantage in business sectors such as international financial services which have regulatory and commercial drivers to conduct international business on a branch basis.

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2.7 S247 TCA - Interest Relief

Ireland’s tax regime for deduction of interest expense incurred on intra group borrowings has been criticised by tax practitioners for being overly complex in the case of borrowings used to finance trading activity and on financing investment in subsidiaries (S247). Failure to meet a series of provisions can result in the denial of relief - sometimes in circumstances where practitioners may consider relief should have applied.

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2.8 Pooling of Foreign Tax Credits for Royalties

Currently the foreign withholding tax suffered on royalty income from a particular country can only be offset against Irish corporation tax attributable to that income.

Unrestricted pooling of foreign tax on royalty receipts is being sought mainly by the software industry. This issue was examined by the Department of Finance in a tax Strategy Group Paper[9] in advance of last year’s Finance Act and found to be potentially very costly for the Exchequer. The static cost of introducing an unrestricted pooling regime was estimated at €150 million. It is important to note however, that this is only a fraction of the potential cost that could arise if companies changed their behaviour by routing additional royalty payments which have suffered levels of foreign withholding tax in excess of 12.5%, through Ireland. The potential cost of this would undoubtedly be multiples of that.

[9] http://taxpolicy.gov.ie/wp-content/uploads/2011/06/10.19-Pooling-of-Royalties.pdf

Pooling of foreign tax on *interest* is currently available where the interest is paid by a 25% subsidiary or fellow subsidiary resident in a treaty country. Introducing a scheme for royalties with similar restrictions to that for interest would benefit a small number of companies but might lead to significantly increased pressure to introduce a much wider scheme. A restricted scheme would not benefit software companies as under the typical structures employed by these companies, royalties are received from third parties rather than subsidiaries.

2.9 SME Sector

The difference between Ireland's personal and corporate income tax rates means that many enterprise activities, even small scale operations, are conducted through companies instead of by individuals as sole traders or by unincorporated entities. If the company's business is successful, the benefit of the 12.5% rate of corporation tax accrues indirectly to the owners of the business through the low rate of tax on the profits of the company - although there is a surcharge on certain profits of close companies.

Close Company Surcharges

Close companies are subject to surcharges on certain undistributed profits. A close company is an Irish resident company under the control of 5 or fewer participators (including associates), or of participators who are directors. The purpose of the surcharges is to counter the avoidance of tax on income arising within a company which would otherwise be subject to personal income tax. There are two surcharges in operation.

A surcharge of 15% applies on 50% of the undistributed trading income of professional close companies. With company profits 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 services or employment to earn and accumulate their income within a company and thereby avoid income tax at the higher income tax rate (plus USC). The surcharge increases the effective corporation tax rate on undistributed income of professional companies from 12.5% to just over 19% - preserving much of the benefit of incorporation where profits are not regularly distributed.

The Commission on Taxation recommended that the professional company surcharge be abolished on the basis that a similar surcharge does not apply to trading companies and that there is no objective rationale for distinguishing between professional companies and trading companies. Abolition of the surcharge would significantly enhance the incentive for professionals to incorporate their business, particularly as the gap between personal tax and corporate tax rates has widened in recent years. On the other hand, extending the surcharge to trading close companies would increase the effective tax rate on retained trading profits of such companies and may have an adverse impact on the funding position of SMEs which have a greater need than professional companies to retain and re-invest business profits.

A surcharge of 20% applies on any undistributed investment and rental income of a close company. While the Commission on Taxation was of the view that this surcharge should be retained, it recommended a significant increase in the €635 exemption limit to ease the regulatory burden on SMEs in operating the surcharge provisions. Increasing the exemption limit may dilute the impact of the surcharge in discouraging the retention of passive non-trading income within a company so as to avoid income tax. A measure of relief is already available to trading companies whereby distributable investment and estate income is reduced by 7.5% before applying the surcharge.

Corporation Tax Relief for New Start-Up Companies

Enterprise Ireland's (EI) most recent annual report shows that Irish companies achieved €14bn export sales in 2010 and that EI's client companies support (directly or indirectly) over 300,000 Irish jobs.

Despite strong performances in some sectors, the Global Entrepreneurship Monitor (GEM) 2010 report for Ireland shows a reduction in the population of entrepreneurs in this country. It estimates that 800 people set up a new business in Ireland each month in 2010 compared to 2,800 people per month during 2008.

Budget 2009 and Finance (No. 2) Act 2008 introduced a measure providing that a new start-up company commencing to trade in 2009 would be exempt from Corporation Tax on profits of the trade, including tax on capital gains on the disposal of trade assets, in each of its first three years to the extent that the total corporation tax liability of the company does not exceed €40,000 in those years. The relief, which has been extended to new businesses commencing in 2010 and 2011, was modified significantly in Finance Act 2011 (see below).

The following are the main provisions of the scheme:

- The relief applies to companies incorporated on, and from, 14th October 2008 that commence to carry on a new trade in 2009, 2010 or 2011.
- The period of relief is three years from the date of commencement of the new trade.
- Relief 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.
- Relief is granted by reducing the corporation tax relating to the trade and chargeable gains of the company.
- Full relief applies where the total corporation tax liability does not exceed €40,000 in any of the years of the three year period. Marginal relief applies 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.
- The relief does not apply to excepted trades (petroleum, mining and land dealing) or to professional services close companies.

Finance Act 2011 modified the relief so that the value of the relief will be based on the amount of employer's PRSI paid by a company in an accounting period, subject to a maximum of €5,000 per employee and an overall limit of €40,000. Credit is also given for any employers' PRSI exempted under the Employer Job (PRSI) Incentive Scheme in respect of a company's employees in determining the amount of corporation tax relief available to the company.

The further extension of the scheme to companies commencing to trade next year, with the same PRSI restrictions as last year, could be considered as part of the Budget / Finance Bill 2012 process. However, it is worth mentioning that start-ups generally do not pay corporate taxes in their first few years of trading due to large start-up losses.

Ireland has simplified measures for tax compliance to ease the burden of compliance on small companies and start-ups. In international surveys, Ireland ranks relatively well in measures of ease of compliance with tax administration requirements across all sizes of company.

2.10 Capital Allowances – Accounting Treatment

As a general rule, a company is not entitled to claim a deduction for depreciation of capital assets and any depreciation charges included in a company's profit & loss account are added back when computing profit for taxation purposes. However, capital allowances are available for certain types of capital expenditure at specified rates.

Ireland's tax depreciation regime applies a single rate of tax depreciation of 12.5% per annum which is applicable to plant and machinery (and motor vehicles subject to a cap of €24,000) and a separate rate of 4% per annum for industrial buildings.

Accelerated capital allowances are available on a limited basis to facilitate investment in specific sectors (eg energy efficient equipment, petroleum exploration and mining), while most of the property-based incentive allowances have been phased out. Ireland's tax depreciation regime is generally competitive for long life assets but less so for assets with shorter useful lives.

In its 2009 report the Commission on Taxation recommended that "*taxable income should be computed for business income (Schedule D, Case I and II) based on the accounting profits of a business, with normal statutory disallowances.*"

This would allow taxpayers to elect to claim tax depreciation in line with accounting depreciation on tangible assets that currently qualify for capital allowances.

Implementing this recommendation would align the tax life of assets with their economic life but would be very costly as it would significantly reduce the business tax base - as recognised by the Commission itself. While accounting rules would have to be complied with, there would be significant scope for assets to be written down for tax purposes at more favourable rates than is the case at present.

Allowing companies to opt for the statutory system or the accounting system would simply mean that companies would opt for the system that optimised their tax position. In addition, rules relating to opting in and out of a system might prove quite complex.

Setting the rates of capital allowances on capital investments is an economic tool available to Government. The loss of this tool should be a consideration also.

There are already some circumstances where tax depreciation can be claimed in line with the accounting treatment. For example, in the case of intangible assets and lessors of short life assets (ie assets with a useful life of less than 8 years).

Programme for Government

The Government for National Recovery 2011-2016 contains a commitment to carry out a cost benefit analysis on accelerating capital allowances on software purchases from 8 years to 3 years.

Consideration should be given to the rationale for giving concessionary treatment to this particular type of "plant and machinery" as there will likely be claims that wear and tear allowances for all plant and machinery should be accelerated at considerable cash-flow cost to the Exchequer. Special provisions for software may also give rise to EU state aid concerns.

Section 3 : International CT issues

3.1 CCCTB – Latest Position

As per the Statement of the Council of the European Union on 21 July 2011, Ireland has declared its willingness to participate constructively in the discussions on the Common Consolidated Corporate Tax Base (CCCTB) draft directive and in the structured discussions on tax policy issues in the framework of the Euro Plus Pact framework.

The Minister has made it clear that in the context of the European Commission having the right of initiation in terms of bringing forward legislative proposals for Member States to consider, there is nothing to be gained from refusing to actively engage on the issue because only in that way can we absolutely ensure that all of the arguments are brought to the table.

In a further development on 16 August last, Chancellor Merkel and President Sarkozy stated in a joint letter to President van Rompuy that member states should commit to finalising the negotiation on the Commission's proposal on a CCCTB before the end of 2012. This issue could fall due for discussion during the Irish Presidency in 2013 although this is by no means certain.

There have been a number of discussions to date on the draft proposal at the Council Tax Working Group Meetings with the more recent discussions focusing on the detailed tax rules to be included in a common tax base. These discussions are likely to go on for a considerable period of time.

3.2 Bilateral Tax Treaties

We have signed double taxation agreements with 63 countries of which 56 are in effect[10]. New agreements with Albania and Hong Kong will be effective from 1 January 2012.

[10] http://www.revenue.ie/en/practitioner/law/tax-treaties.html

The ratification processes for new agreements with Bosnia & Herzegovina, Kuwait, Montenegro and Morocco have been completed in Ireland and await the completion of ratification in these countries before they come into effect. Proceedings to ratify the new agreement with Armenia are being pursued at present. An agreement to replace the existing agreement with Germany was signed on 30 March 2011 and the ratification process for this agreement is also being advanced. Negotiations for new agreements with Saudi Arabia, Panama, Ukraine and Uzbekistan have been concluded and it is hoped to have these signed before the end of the year. This would bring the total number of signed agreements to 67.

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3.4 Effective Tax Rates

The amount of tax that a company pays is a function of the tax rate that applies in the country in which the company operates and the tax rules or tax base applying in that country – which includes rules on what deductions can be allowed to reduce the overall tax bill.

Measuring effective tax rates (ETR) is extremely difficult. Most countries have very complex tax rules which make it difficult to estimate the real effective tax rate applying to particular companies in particular sectors. There is no single agreed source of accurate information on effective tax rates although the OECD and the European Commission have done studies from time to time. Most of these studies suggest that effective tax rates are lower than headline tax rates but not significantly so. xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx

However, a number of reports have recently suggested that the effective tax rates that apply in some European countries may be considerably lower than previously thought. The most prominent of these reports was carried out by the World Bank, in conjunction with PwC (PricewaterhouseCoopers), which produces an annual Doing Business report that includes a robust measurement of ETR across 183 countries[11].

The World Bank/PwC report found that:

[11] http://www.doingbusiness.org/

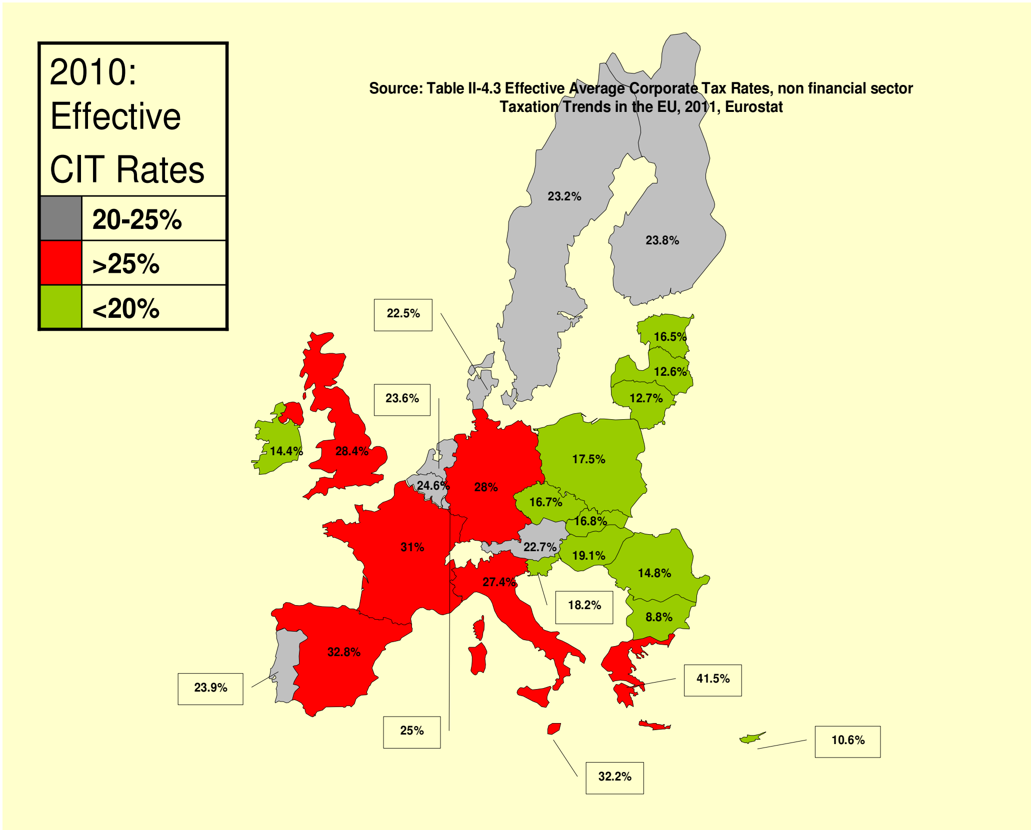
- in the EU overall, the average statutory rate is 22.5%
- the average effective tax rate is 13.1%
- the lowest statutory rate in the EU is 10% (Bulgaria, Cyprus)
- the highest is 34% (Belgium)
- Ireland's effective tax rate is 11.9% - at only 0.6% below the statutory rate this represents the smallest difference between ETR and statutory rates in the EU
- eleven EU countries have effective tax rates lower than Ireland, including Luxembourg, Belgium and France at 8.2%[12]

The table below, taken from that report, shows the effective tax rates and the statutory corporate tax rates for EU members. In the EU overall, the average statutory or headline rate is 22.5%, the average ETR is 13.1%.

	Effective Corporate Tax Rate	**Statutory Corporate Tax Rate**	**Difference between the Effective and Statutory Rates**
Austria	15.7%	25.0%	9.3%
Belgium	4.8%	34.0%	29.2%
Bulgaria	4.6%	10.0%	5.4%
Cyprus	9.4%	10.0%	0.6%
Czech Republic	7.4%	20.0%	12.6%
Denmark	21.9%	25.0%	3.1%
Estonia	8.0%	21.0%	13.0%
Finland	15.9%	26.0%	10.1%
France	8.2%	34.4%	26.2%
Germany	22.9%	29.8%	6.9%
Greece	13.9%	25.0%	11.1%
Hungary	16.7%	21.3%	4.6%
Ireland	11.9%	12.5%	0.6%
Italy	22.8%	31.4%	8.6%
Latvia	6.5%	15.0%	8.5%
Lithuania	0.0%	20.0%	20.0%
Luxembourg	4.1%	28.6%	24.5%
Netherlands	20.9%	25.5%	4.6%
Poland	17.7%	19.0%	1.3%
Portugal	14.9%	26.5%	11.6%
Romania	10.4%	16.0%	5.6%
Slovakia	7.0%	19.0%	12.0%
Slovenia	14.8%	21.0%	6.2%
Spain	20.9%	30.0%	9.1%
Sweden	16.4%	26.3%	9.9%
UK	23.2%	28.0%	4.8%
Norway	24.4%	28.0%	3.6%
Switzerland	8.9%	21.3%	12.4%
US	27.6%	39.0%	11.4%
EU Average	13.1%	23.1%	10.0%

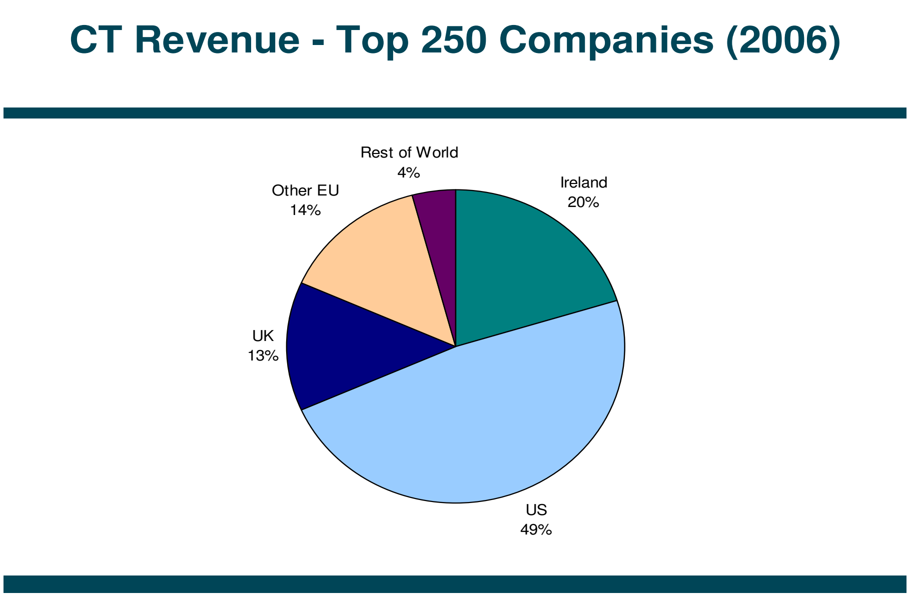
The European Commission has also published data on taxation trends in the EU, based on analysis carried out by the German Institute ZEW and Eurostat. The effective corporate tax rates resulting from that analysis are shown below.

[12] The authenticity of this study has been questioned by many commentators because the results were based on a hypothetical domestic company with no imports or exports



3.5 China and the BRICS

As can be seen from the chart below, foreign companies contribute a large part of Ireland's CT revenue, with the largest share coming from US multi-nationals.



This illustrates how successful Ireland has been in attracting foreign direct investment. However, we must ensure that we remain competitive and adapt to changing markets. A lot of FDI is going to the so called BRICS countries (Brazil, Russia, India, China and South Africa).

The five BRICS countries comprise more than 2.8 billion people or 40% of the world's population, cover more than a quarter of the world's land area and account for more than 25% of global GDP. To date, the scale of China's economy and pace of its development has out-distanced those of the other BRICS. China alone contributed more than half of the BRICS countries share and greater than 15% of the growth in world economic output from 2000 to 2008.

Almost 20% of imports into the EU originate in China but Irish exports to China account for approximately 2% of our total exports.

3.6 Other issues impacting on investment decisions

When considering how best to attract FDI into Ireland, it is important to recognise the range of issues, other than tax, that can affect investment decisions such as :

- The availability of suitable personnel and infrastructure
  The US in particular enjoys a competitive advantage in this area
- High marginal rates of income tax
- High taxes on labour
- The costs of doing business across jurisdictions.
  For example, jurisdictions such as Slovakia are able to compete for R&D expenditure without R&D tax incentives due in part to its competitive cost base
- Availability of air access routes
- Availability of American and International schools
- Relationships with Revenue authorities
- Political and economic stability

The World Bank's annual "Doing Business" report ranks economies in order of the ease of doing business in that economy[13]. This index averages the country's percentile rankings on nine topics; including starting a business, dealing with construction permits, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and closing a business.

Ireland ranks 9th out of 183 countries surveyed, making it the highest ranked Eurozone country and the third highest EU country, behind the UK and Denmark.

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

Business Tax Team
October 2011

[13] http://www.doingbusiness.org/rankings