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7 March 2022

Consultation on Territoriality,
Tax Division,
Department of Finance,
Government Buildings,
Upper Merrion Street,
Dublin 2
D02 R583

BY EMAIL TO: intltax@finance.gov.ie

Re: **Response to Consultation on Territorial System of Taxation**

A Chara,

1. Introduction

We welcome the opportunity to respond to the Department of Finance's ("**the Department**") Consultation on a Territorial System of Taxation ("**the Consultation**"). As a policy matter, we consider it hugely beneficial that the Department engages in regular and detailed consultations and feedback statements, on a broad range of tax policy matters. Taking this proactive approach will ensure a more reflective and principled approach to tax policy in Ireland.

Given that the subject matter of the Consultation will result in major legislative changes which are very technical in nature, we would encourage the Department to publish all draft tax legislation arising in full for technical consultation with interested stakeholders.

In preparing our response to the Consultation, we engaged with our clients that are most likely to be affected by the Irish approach to a foreign dividend and branch location. These are all multinationals that regularly make investment decisions. All of them have practical experience of the tax regimes in a wide range of countries. While the responses in this submission reflect only our view, we thought it would be useful to include a flavour of the conversations we had with our clients as follows:

"The complexity of Ireland's worldwide tax system is precisely the reason we generally avoid using Ireland as a holding company jurisdiction in favour of European jurisdictions with established participation regimes."

"Replacing the dividend tax and credit system with a broad dividend exemption, and broadening the application of the participation exemption on capital gains, would make Ireland materially more attractive as a holding company jurisdiction. The current rules are less attractive in certain respects compared to the UK and Luxembourg approaches in these areas."

"Simplicity and certainty on the dividend taxation regime is key to decisions in our group in respect of the location of holding companies. We consider both the headline rules and their practical application so that there are no surprises following implementation."

"Ultimately an exemption system is not going to lose Ireland tax revenue. If anything this makes Ireland more competitive as an EU Holding company location post Brexit and they will gain tax contribution from non-corporate tax sources e.g. social security, indirect taxes etc. through the location of jobs in Ireland."

"The significant tax regime changes proposed under Pillar One and Pillar Two together with the Shell entities directive has triggered a review of holding company structures and Ireland should act quickly to ensure that a more attractive participation exemption for dividends can be factored into the analysis before decisions are made."

"Ireland's current regime gives rise to issues with funding external dividend payments out of holding companies and because of the uncertainties in applying the credit system dividends are often avoided in favour of intra-group debt. This is a suboptimal situation particularly with many of the ATAD/BEPS measures targeting intra-group debt and difficulties with distributable reserves."

"Dispensing with a potentially restrictive "trading" (which has no meaning outside Ireland and the UK) activity requirement for a foreign branch exemption and moving to a broader "business" activity requirement is important. This is an area where issues have sometimes arisen under the UK's foreign branch exemption."

"A new Irish distribution and foreign branch exemption should be elective as it is in the UK. These features have not been problematic in the UK or undermining of the simplification objective of the exemption system (i.e. reduction of uncertainty and unnecessary compliance burden)."

"Any changes to Schedule 24 (for the minority of taxpayers who want to use it) should not be at the expense of delaying the introduction of the exemption i.e. you could introduce the exemption and then simplify Schedule 24 the following year."

"Appreciating that this Consultation isn't really seeking views on interest deductibility (except for the limited question on interaction with a new participation exemption regime), it would still be a good opportunity to signpost that this really should be next on the list of areas to bring Ireland's regime into the 21st Century."

"The existing interest rules surely disfavour Ireland as a jurisdiction for raising and deploying MNE corporate debt finance, so making Ireland relatively unattractive as a parent company location."

2. Responses to questions in the Consultation

Please note that in our response we have grouped some of the questions raised in the consultation.

Question 1

What is your opinion of Ireland's corporate tax potentially moving from the current worldwide system with credit relief for foreign tax to a territorial system of double taxation relief, including participation exemption and/or branch exemption provisions?

It is our belief that Ireland should move to a full participation exemption for dividends and foreign branch profits with effect from 1 January 2023. This would mean only taxing profits of foreign corporates and foreign branches under the Controlled Foreign Company ("**CFC**") rules and not otherwise.[1] To deal with any drawbacks or concerns that may arise in the specific circumstances of a taxpayer group we propose that the exemption system should be elective.

The complexity of the current credit system gives rise to considerable difficulties for Irish headquartered groups and foreign multinationals in claiming double tax relief. As with many of our tax provisions, the double tax relief provisions have gone through various "sticking plaster" amendments to deal with developments in this area including EU case law. The result of this approach is that the current system includes a myriad of rates and reliefs applicable to foreign income and the complexity of this system, which requires the tracing of the source of the foreign dividends and related tax credits, creates significant uncertainty for these groups. Where the quantum of such income is significant, this can represent an unacceptable tax exposure for a multinational group even though the current regime is not (and should not be) a significant revenue generator for the Irish exchequer. In addition, even where there is reasonable certainty with regard to the availability of tax credits there is a significant compliance burden associated with calculating and evidencing the available credits and maintaining appropriate records.

Irish holding companies have already waited a long time for this regime to be implemented and any further delays could be detrimental to Ireland's competitiveness as a holding company location. Various reasons for the delay have been given by Government, including that Ireland did not have a CFC regime, that Ireland did not have a broadly applicable transfer pricing regime or that there was insufficient time or capacity in Government to implement it, notwithstanding that the introduction of CFC rules and broadly based transfer pricing rules were well flagged in advice of their introduction. There are now no barriers to the introduction of a full exemption system so there is no reason to delay. All that is being requested is to conform the Irish system to an international norm: an exemption system for foreign dividends and branches.

We appreciate that with international and EU tax proposals such as the Anti-Tax Avoidance Directive[2] ("**ATAD**"), the Organisation for Economic Co-operation and Development ("**OECD**") Pillar One and Pillar Two proposals and the new EU Unshell proposal[3], the resources of the Department of Finance and the Revenue Commissioners have been and continue to be constrained. However, the implementation of these proposals should be seen as an additional reason for the immediate introduction of a full exemption system rather than a barrier to it. Layering these measures over Ireland's unusual tax regime (it differs from most EU/OECD countries) is likely to cause additional complexity and

[1] There are other rules that would also apply to attribute foreign profits to Ireland such as the transfer pricing rules and section 590 TCA, Part 33, Chapter 1 etc. and these should be retained.

[2] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

[3] Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU

potential mismatches in applying the Irish tax rules so, we believe, will utilise greater resources of the Department of Finance and the Revenue Commissioners.

This international tax reform will influence decision-making within multinational groups. For example, holding companies are becoming increasingly linked to other business activities with significant employment due to substance rules (including most recently the EU Unshell proposal). As a result, Ireland risks losing businesses providing employment in Ireland if its holding company regime is not competitive with other EU and OECD countries.

The long and tortuous FII litigation[4] in relation to the taxation of dividends ended with a statement of principle from the European Court of Justice that dividends from one EU Member State should be treated in the same way as domestic dividends. The judgment defined an outcome to be achieved rather than the methodology for achieving that outcome, i.e. our system is only compliant with EU law in so far as it achieves that outcome. Ireland taxes foreign dividends but exempts Irish dividends. The credit system is acknowledged to be imperfect so a move to a full exemption system seems inevitable as Ireland is not in compliance with EU law.

The Irish taxes code historically only taxed distributed profits of subsidiaries (subject now to CFC rules). In the light of the decision in *ICI v Colmer*[5], it is illegal to distinguish between branches and subsidiaries in this context, i.e. if EU law were to be applied correctly in Ireland now, non-Irish branches should be exempt from tax in Ireland until their profits were distributed in the same way that subsidiaries' profits are exempt until distributed. If the principles from the FII case and *ICI v Colmer* are fully integrated, the outcome must result in a participation exemption for dividends and a full branch exemption. We understand that the legal requirement may only extend to EU subsidiaries and branches but it follows that this correct policy should be extended to non-EU subsidiaries and branches. From a practical perspective, we understand that Ireland generates very little tax from the foreign operations of Irish companies. This is a correct outcome as Ireland should tax activities in Ireland and not elsewhere. The economic rationale for taxing corporate activity is that since these activities utilise the infrastructure of the State they ought to contribute to the cost of that infrastructure. Where a company's activities are outside of Ireland and do not use the infrastructure of the State, they should not contribute to the cost of that infrastructure. It is also consistent with the long-term Irish tax policy of taxing substantive activities and not merely letterbox companies.

In testing the benefits and burdens of the alternatives of "territorial" and "worldwide with foreign tax credit", it may be useful to first identify the problem to be solved. Ireland's current economic model is based in large measure on a service economic model rather than on heavy industry with attendant heavy capital investment in factory and mechanical equipment. This is because, as a peripheral island nation, it is not efficient to locate heavy industry in Ireland.

Prior to the adoption of the CFC regime in the United States in 1962, the normal rule among developed countries that exported capital to foreign direct investment in foreign subsidiaries was to tax the shareholder upon receipt of a distribution from a foreign corporation. The corporation, in turn, was the point of first beginning in exercising taxing rights. Foreign corporations were typically taxed only on their income from sources in a country based on the nexus of the corporation's income with the taxing country. Direct taxation of a foreign corporation by the country of residence of shareholders was excluded under the basic treaties entered into after 1945. The shareholder of a foreign corporation was taxable, if at all, by its residence country only upon distribution of dividends to it.[6]

In 1961 in the United States, the Kennedy Administration moved to change the basic architecture of the taxation of US companies' foreign direct investment. The stated reason for this change was to

[4] Case C-446/04 - *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue* (12 December 2006)

[5] [1999] WL 1019530 - *Imperial Chemical Industries v Colmer (Her Majesty's Inspector Of Taxes)*

[6] See, e.g. the Model Bilateral Conventions for the Prevention of International Double Taxation and Fiscal Evasion, League of Nations Doc. C.88.M.88. 1946 II A. (1946)

level the playing field between comparative investment in domestic (U.S.) plant and equipment and potential alternative foreign direct investment.[7] This is the capital export neutrality rationale. It does not apply to a capital importing country such as Ireland. The concern was that the longstanding rule of taxing shareholders only on receipt of distributions from foreign subsidiaries provided a tax subsidy to foreign direct investment. The concern was not revenue raising, although some increase in tax receipts was intended.[8] This incentive was characterized as "deferral."[9] Beginning about 10 years later, other OECD countries began to adopt their own CFC regimes.[10]

The other basic building block under the classic system (taxation of all foreign income, including shareholders on actual distribution of foreign dividends) was to allow credits for source country tax on income against the residence country (capital exporting country) residual tax on income derived abroad. Tax policy discussions have long debated the benefits and burdens of "cross crediting" foreign taxes on one grouping of income against other foreign source income. Different jurisdictions have come out at a range of acceptable levels of cross crediting. Again, the concern has usually included a major focus on the effects of the foreign tax credit on location decisions for direct investment: does cross crediting under the foreign tax credit regime establish preferences for foreign direct investment over domestic direct investment alternatives?

In the Irish economic model, where the bulk of the capital is imported and is either deployed in Ireland or elsewhere (i.e. a capital allocation hub). There is no valid economic argument for taxing non-Irish profits. On the contrary, shareholder level tax on capital deployed by Irish capital allocation hubs merely increases the cost of operating an Irish holding company.

The United States conversion to a territorial system in 2017 was comprised of a combination of a dividend exemption territorial system and a minimum tax on foreign profits[11] to minimize any incentive to make foreign direct investment instead of domestic U.S, direct investment.[12] In the current Irish environment, such combination of goals and policies should be addressed by separate measures. A full exemption system will provide the benefits of simplicity and elimination of cross crediting. As with the United States, and its Global Intangible Low Taxed Income ("**GILTI**") regime, Ireland can address separately the EU concerns about "the race to the bottom" by adopting appropriate Pillar Two legislation in due course together with Ireland's existing CFC rules.

Full territoriality should be consistent with the decision of the Court of Justice of the European Union "**CJEU**" in ***Cadbury Schweppes***,[13] which only permitted the taxation of foreign profits of another EU member state where the foreign operations lack genuine commercial activities. Also, for a capital importing country like Ireland, imposing a CFC charge on the basis of capital export neutrality is irrational as it discourages the importation and deployment of capital from Ireland. Since much of that deployment is to non-EU member states, it must follow that non-EU subsidiaries and branches must be subject to the Irish CFC rules in the same way as their EU counterparts. As the current Irish CFC rules

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[7] Message from the President of the United States Relative to our Federal Tax System, April 20, 1961, reproduced at H.R. Doc. 140, 87th Cong. 1st Sess at pp 139 et seq.

[8] Statement of Secretary of the Treasury Douglas Dillon, May 3, 1961, reproduced at H.R. Doc. 140, 87th Cong. 1st Sess at pp

[9] Id., at p. 170.

[10] Germany (1972), Canada (1975), Japan (1978), France (1980), the UK (1984). See Avi-Yonah, "International Tax as International Law," 57 *Tax Law Review* 483 (2003-2004)

[11] The Global Intangible Low-Taxed Income or GILTI regime.

[12] 1 US Department of the Treasury, "Unified Framework for Fixing Our Broken Tax Code," September 27, 2017, https://www.treasury.gov/press-center/press-releases/Documents/Tax-Framework.pdf ("STOPPING CORPORATIONS FROM SHIPPING JOBS AND CAPITAL OVERSEAS To prevent companies from shifting profits to tax havens, *the framework includes rules to protect the US tax base by taxing at a reduced rate and on a global basis the foreign profits of US multinational corporations*. The committees will incorporate rules to level the playing field between U.S.-headquartered parent companies and foreign-headquartered parent companies.")(Emph added)

[13] Case C-196/04 *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* (12 September 2006)

are compliant with ***Cadbury Schweppes***, they should not be extended beyond the current scope: the artificial diversion of profits from Ireland to a subsidiary/branch in a foreign country only in cases where that subsidiary/branch lacks genuine commercial activities.

The outcome of the introduction of a full participation exemption to subsidiaries and branches and the retention of the existing scope of CFC rules would be to move Ireland's taxation of subsidiaries/branches to a more normal European-style tax system. As far as we are aware, Ireland is the only EU country that still imposes a tax and credit system for dividends. In recent years both the UK and the US have moved away from a tax and credit system to a participation exemption system. Ireland is one of only four OECD countries which does not have a participation exemption for dividends. The complexity of the current Irish regime, when compared to the simplicity of the dividend exemption regime available in most OECD countries and all other EU countries, creates an unnecessary compliance burden and reduces Ireland's competitiveness in attracting new investment and in retaining existing Irish headquartered companies. Ireland should cease to be an outlier in this aspect of its tax system.

The CFC rules, transfer pricing rules, Part 33, Chapter 1, Section 590 of the Taxes Consolidation Act 1997 (as amended) ("**TCA**") and other similar rules provide adequate protection for the artificial diversion of profits away from Ireland to non-Irish subsidiaries, and the rules can be simply applied to exempt branches by treating branches as if they were subsidiaries, as required by EU law.

Question 2

What would the broad benefits be for multi-national enterprises if Ireland were to move to such a system?

The *Review of Ireland's Corporation Tax Code* (the "**Coffey Report**") noted that the rationale for the introduction of participation exemption regimes by other countries in recent years has primarily been to enhance the competitiveness of domestic tax regimes by:

(a) improving the position of domestic firms when they expand outside Ireland;

(b) improving the attractiveness of the Corporate Income Tax ("**CIT**") for Irish holding companies which are used by corporate groups to gather together and deploy the capital in their businesses; and

(c) reducing what may be a non-trivial compliance burden on domestic outbound investors.

We consider that these points are valid in the context of Ireland's dividend and branch regime and that Ireland has fallen behind other countries in continuing with a complex credit regime.

It is acknowledged by many commentators on the Irish holding company regime that in most cases additional Irish tax is not paid on foreign dividends and therefore it is expected that a foreign dividend exemption would not give rise to a significant cost to the Irish exchequer. The Coffey Report noted that:

> *"In practice, Irish resident companies with foreign subsidiaries will not pay tax on the profits of such subsidiaries as companies will utilise the pooling of dividends and timing of dividends payments to 'mix' credits from high tax and low tax jurisdictions, retain earnings overseas for reinvestment rather than face a potential Irish tax liability, or realise profits as a chargeable gain through the disposal of shares in, or liquidation of, a foreign subsidiary to avail of the s. 626B TCA 1997 exemption. Stakeholders have noted that the application of foreign credit is complex to apply in practice, particularly where an Irish resident company owns companies in multiple jurisdictions."*

In addition to the complexity of the calculations required under the current credit regime governed by Schedule 24 TCA, there are also complexities in interpreting Schedule 24 in the context of normal commercial transactions undertaken by international groups. These include:

1. The procedure for claiming relief under Paragraph 9B of Schedule 24 TCA in respect of distributions which are not dividends for foreign company law purposes;

2. Difficulties arising where companies join and leave “consolidated groups” in circumstances where section 9G of Schedule 24 TCA applies;

3. Complexities in applying Paragraph 9H of Schedule 24 TCA to some forms of foreign merger;

4. Where a claim for relief under Paragraph 9I of Schedule 24 TCA is made in circumstances where the dividend is paid out of profits attributable to a share buyback *in specie* distribution or other distribution rather than a dividend;

5. The procedure for claiming relief for non-cash *in specie* distributions many levels down in a group, which are not regarded as dividends for Irish company law purposes;

6. Complexities which arise where a dividend is paid from an Irish company to an EU intermediate holding company, which then pays a dividend from those profits onto Ireland; and

7. Requiring dividends to be attributed to a particular year based on the year in which the profits were declared for local company law purposes as this can give rise to complexities where there are differing rules and concepts in foreign corporate law, i.e. there may be no way to attribute the dividend under local law

Where these issues arise and create uncertainty in commercial transactions, they often present an unacceptable tax exposure for the companies involved, particularly where the amount of relief is significant. This includes cases where dividends are paid from countries with higher tax rates than Ireland such that no additional Irish tax should arise, but proving this is hugely complex.

Uncertainties with regard to the taxation of dividends can give rise to issues for Irish headquartered groups paying external dividends. While dividends may be funded from intra-group debt this results in increased intra-group leverage which gives rise to other tax complexities (transfer pricing, interest limitation etc.) and does not create distributable reserves from a company law perspective. Also it runs counter to good corporate governance and to efficient capital allocation.

While the specific issues mentioned above focus on foreign dividends, the practical application of Schedule 24 to branch profits also gives rise to complexities and this is of particular significance in the financial services industry where it is common for commercial reasons to operate foreign businesses as branches rather than subsidiaries.

Question 3

Are there any particular drawbacks or concerns for multi-national enterprises which should be considered if Ireland were to move to such a territorial system of double tax relief, including any indirect consequences or risks?

While a territorial system will result in a more straightforward position for most groups, it may have drawbacks in certain circumstances including, for example, where:

1. Branch losses are currently available to offset profits. This is easily addressed by having an elective exemption so that taxpayers have the flexibility to elect out of the more complex tax credit system and into the exemption system where that causes uncertainty but with the option

to remain under the existing system for those companies for whom the election would be disadvantageous; and

2. Ireland retains taxing rights under a double taxation treaty under provisions similar to Article 8 of the OECD Model Convention and exempting those profits in Ireland could give rise to unintended anti-hybrid and foreign tax consequences. This is easily addressed by only exempting branches or permanent establishments which are taxed as such locally.

The drawbacks from not introducing a foreign dividend and branch exemption are more significant and will cause more issues once the OECD international tax measures (Pillar One and Pillar Two) are implemented as the interaction between profit allocation under these rules and our dividend and branch taxation system will be extremely complex.

Question 4

Are there particular examples of best practice associated with a change to territoriality in other jurisdictions which could be considered, with a view to reducing compliance burdens without increasing avoidance risks?

We attach at Appendix I a summary schedule of current dividend participation regimes in a number of major jurisdictions and note the following design considerations:

1. In most cases a full 100% exemption is granted;

2. In many cases a minimum percentage holding and a specified holding period is required; and

3. The rules around residence of the subsidiary vary from no requirement, to a Double Taxation Agreement ("**DTA**") or EU/EEA requirement with others merely excluding EU Blacklist countries. We propose a 100% exemption should apply for all foreign source dividends irrespective of whether they are derived from EU treaty or non-treaty locations (similar to the UK as discussed below). This proposal is made in the context of the various strands of international tax reform including the imminent Pillar One and Pillar Two (which 137 countries have agreed to) such that it would be poor policy to restrict benefits only to dividends from EU/EEA or DTA countries.

The UK dividend exemption regime merits specific consideration. Except in the case of small companies, the UK regime does not contain a residence test in respect of the payer jurisdiction and is broadly applicable subject to targeted anti-avoidance and required very limited transitional measures. Given the similarities of the UK and Irish tax regimes and legal concepts together with the fact that the UK moved from a system broadly similar to our current system to a full participation exemption regime, we consider that the design of the UK dividend exemption regime should be compatible with Irish tax law. We understand that the UK dividend exemption works well in practice for both taxpayers and Her Majesty's Revenue and Customs ("**HMRC**") and that there was a smooth transition from their tax and credit system.

Like most EU countries, the UK also has a full branch profits exemption regime, which includes the following design elements:

1. The regime is by election on a company-by-company basis;

2. The exemption includes capital gains (except for certain gains of close companies) and passive income of a trading branch;

3. The branch must be trading. For the reasons mentioned at question 7 we would not favour the inclusion of a trading requirement on the basis that this is not an internationally recognised concept. Many other regimes including France and Germany

have a requirement that the branch must be engaged in genuine business activity and we consider that together with appropriate anti-avoidance provisions this would afford adequate protection;

4. Where an asset is transferred to the branch, part of the gain on disposal is attributed to the head office;

5. CFC rules are adapted to apply to branches; and

6. Transitional rules where losses claimed by head office in the period prior to exemption election.

Question 5

Taking account of the above, what in your view would be the potential impacts of moving to a participation exemption regime as set out in the Coffey Report?

The key impact of moving to a participation exemption regime is reducing the complexity, uncertainty and unnecessary compliance burden of our credit system for Irish taxpayers. This should increase Ireland's competitiveness and based on the Coffey Report, this can be achieved without a material reduction in tax revenues because Schedule 24 TCA is already in effect and ensures a *de facto* participation exemption for foreign source dividends and foreign branch profits in most instances by its foreign credit mechanisms including credit pooling etc. However as noted above the uncertainties raised by the current system can represent an unacceptable tax exposure for a multinational group.

International tax is becoming more and more harmonised through various OECD and EU initiatives and continuing to layer these measures on top of Ireland's complex tax regime causes additional complexity and potential mismatches in rules.

The completion of the transposition of the ATAD into Irish law in the Finance Act 2021, the expansion of our transfer pricing regime and the imminent transposition deadlines for the Pillar One and Pillar Two proposals affords an opportunity to simplify Ireland's corporate tax code and to introduce a foreign dividend and branch participation exemption, which would ensure Ireland is on an even playing field with other EU member states and OECD countries. Ireland has the opportunity now to draft an exemption system which is fully compatible with all of these reforms and to take advantage of group restructurings which may occur as a consequence of these reforms. However timing is key to maximising this opportunity as decisions will be made in the short term and our current regime will put us at a competitive disadvantage.

Question 6

Are there particular considerations or design features that should be considered in reviewing the basis of the Irish corporation tax system?

A key design feature for a new regime is simplicity. Where a new regime is complex, the potential for increasing Ireland's competitiveness is reduced because complexity can negatively influence decision makers when selecting holding company locations. This is the key issue with the current regime - in many cases while it is considered likely that no Irish incremental tax will be due based on particular taxpayer circumstances, the complexity of the regime raises an element of doubt.

The regime must also afford the relevant protections against tax avoidance but these should be limited to circumstances where pre-existing rules (including the General Anti-Avoidance Rules in section 811C TCA) are insufficient to deal with such avoidance.

In addition to our existing specific and general anti-avoidance provisions, the Irish tax regime has been reformed over recent years including the imposition of EU and OECD measures to combat tax avoidance including:

1. The introduction of an ATAD compliant CFC regime including additional defensive measures in respect of those countries that are on the EU list of non-cooperative jurisdictions for tax purposes (the "**EU Blacklist**");[14]

2. Anti-hybrid and anti-reverse hybrid rules;

3. Interest limitation and additional specific anti-avoidance provisions in recent years in respect of interest relief under section 247 TCA;

4. ATAD compliant Exit-tax;

5. Extension of Irish transfer pricing rules to non-trading transactions;

6. Adoption of the OCED 2017 transfer pricing guidelines and branch profit attribution rules;

7. Country by country reporting (to be followed in 2024 with public country by country reporting); and

8. DAC6.

Ireland will also transpose the EU directive on Pillar Two (global minimum effective tax rate) and has agreed to sign up to the OCED Pillar One initiative. In addition, a draft EU directive on shell entities has been published. In our view the combination of all of these measures together with some minor additional protections and transitional measures as outlined at question 7 below, should be sufficient to deal with any tax avoidance concerns.

Question 7

Taking account of, but not limited to, the design elements above, what in your view would be the best regime for Ireland to transition to, should a change take place? Please elaborate with consideration of the impacts, benefits and potential drawbacks both of (a) your preferred approach and (b) any approaches which you do not think would be beneficial.

The design elements listed in the consultation are as follows:

1. A wider participation exemption than is currently provided for gains;

2. Limit to dividends paid out of trading profits of companies;

3. Limit to foreign branch trading income; and

4. Limit participation exemption and/or branch exemption to specified categories of jurisdictions, e.g. DTA-partner countries and EU member states, while retaining the worldwide charge with credit for foreign tax for other jurisdictions, including, for example, EU Code of Conduct-listed jurisdictions.

For the reasons outlined above we propose a more broadly based dividend exemption rather than an adaptation of the Capital Gains Tax ("**CGT**") participation exemption. In particular the limitation on the country of residence of the investee company may make it more difficult to apply in the context of

[14] The countries currently included on the Blacklist are American Samoa, Fiji, Guam, Palau, Panama, Samoa, Trinidad and Tobago, US Virgin Islands and Vanuatu.

dividends if it is intended to look through to the underlying profits where those profits may derive from sources outside of jurisdictions qualifying for the CGT participation exemption. Also, it would simply mean that investment from Ireland would be made through another EU or DTA country so that no additional tax would be raised.

In relation to the CGT exemption itself we are of the view that the system would benefit from the elimination of the trading requirement for third party disposals and the introduction of a genuine business activity test like that in the Cadbury Schweppes case. Secondly, the definition of residence should be widened to include certain countries, which do not have a generally applicable concept of residence (e.g. Hong Kong). Where a company is resident in a territory under the terms of a DTA, it should be treated as resident there for the purposes of the participation exemption. Perhaps a less complex and clearer approach would be that all companies other than those resident in an EU Blacklist country should be included. Once the conditions for a dividend exemption are fixed, the CGT participation exemption should be aligned.

The simplicity in a full dividend and branch exemption is key to the success of any scheme. Limitation by reference to factors such as whether the activity is trading in nature causes uncertainty particularly for taxpayers outside Ireland and the UK where this is not a familiar concept. The analysis of trading versus passive /capital activities can be complex and, in many cases is unfamiliar to foreign decision makers, as most tax systems do not delineate activities in this manner. An example of this in the recent *Perrigo* case,[15] which highlighted the fine line between trading and capital activities for Irish tax purposes and led to high profile stock exchange announcements by Perrigo due to the scale of the tax liability at stake. We understand that while the UK branch exemption system generally works well, this particular condition has been the cause of uncertainty in some cases. Also "trading" is a concept that is only recognised or understood in a small number of countries so we encourage the Department to look beyond the UK in this post-Brexit world.

We would propose the following features for the branch profits exemption:

1. An optional election on a branch-by-branch basis for the application of the branch exemption;

2. The branch exemption would apply only where the branch is "subject to tax" in the foreign jurisdiction. As Pillar Two is introduced this will align neatly with the global minimum tax rate;

3. The exemption would apply to all genuine business activities including trading, passive income and capital gains associated with such activities;

4. The Irish exit tax regime would be amended to ensure that unrealised capital gains which have accrued on an asset prior to its transfer to a foreign exempt branch will be taxed in Ireland when the asset is ultimately disposed;

5. The Irish CFC regime would apply to any branches which have been elected for exemption;

6. Where the branch is not elected exempt, a simplified tax credit system should be adopted to allow double tax relief for foreign taxes paid; and

7. Transitional rules could be introduced to postpone the exemption for a period where branch losses have been claimed against profits of the head office business in the previous 3 or 4-year period. This may be required to avoid a situation that the branch losses are used in Ireland in year 1 to reduce year 1 head office profits but for foreign tax purposes are carried forward

[15] *Perrigo Pharma International Designated Activity Company v John McNamara, the Revenue Commissioners, the Minister for Finance, Ireland and the Attorney General* [2020] IEHC 552

against the branch and used in years 2 and 3 against branch income. This might otherwise result in double non-taxation.

We would propose the following features for the dividend exemption:

1. To maximise Ireland's competitiveness and ensure a clear and simple code, a 100% exemption should apply for all foreign source dividends irrespective of whether they are derived from treaty or non-treaty locations. This broad application (similar to the UK regime) would help Ireland become more competitive as a holding company location relative to other nations;

2. It would be reasonable to apply a minimum ownership and holding period that the Irish company would have to possess in a foreign subsidiary to qualify for an exemption for foreign dividend income. One such example would be the 5 per cent holding requirement outlined in section 626B TCA;

3. The dividend exemption could be disapplied where the payer has obtained a tax deduction. This would be in line with the ATAD anti-hybrid rules;

4. The exemption should be optional on an investee company by company basis;

5. Double tax relief for underlying taxes would not be available where the dividend exemption election is made; and

6. Schedule 24 TCA should be simplified for any non-exempt dividends or profits in respect of which double tax relief will continue to apply so that relief would be available for foreign tax suffered by whatever name.

Question 8

Please outline your view of whether Ireland's CFC rules would be adequately aligned with participation exemption and/or branch exemption regimes should these be introduced. What synergies or risks, if any, do you foresee arising?

Question 9

Please identify any particular design features of these exemption regimes that could have positive or negative impacts in this context? Please elaborate.

Question 10

Please identify any adaptations to Ireland's CFC rules that should be considered in conjunction with the introduction of such exemption regimes.

The CFC regime is aligned with the branch/dividend exemption on the basis that it prevents artificial diversion of income from Ireland. Also all EU countries which already have dividend exemption regimes must also have an ATAD compliant CFC regime. The existing CFC rules, transfer pricing rules and section 590 TCA provide adequate protection for the artificial diversion of profits away from Ireland to non-Irish subsidiaries and the rules can be adapted as follows to accommodate a branch exemption:

- Where the profits of a branch are exempted under a branch exemption regime, the CFC regime should apply to such profits in the same way that it applies to foreign subsidiaries; and

- Where profits are subject to a CFC charge, they should be exempt under the dividend/branch exemption on reparation to Ireland.

Otherwise, there is no valid economic or policy rationale for expanding the current scope of the Irish CFC rules.

Question 11

In your view, should tax relief for funding costs of investments be reviewed, with a view to restrictions, if foreign income from such investments were to be exempted? What EU law or tax treaty constraints, if any, might impede such restrictions?

As discussed above we propose an optional branch and dividend exemption so that companies can decide on a case-by-case basis whether to apply the exemption. Where the exemption option is not exercised, there should be no restriction of tax relief for interest.

While dividends and branch profits accruing to an Irish group are currently taxable, it would be unusual for interest relief, including relief under section 247 TCA, to be claimed against foreign dividend income and due to the operation of Schedule 24 TCA in many cases no additional corporation tax is due. Therefore, in our view there should be no requirement to further restrict interest relief as there is no real change in the tax position of most companies.

Under current rules, Irish groups may claim interest relief on loans to acquire or lend to Irish and non-Irish companies where the strict conditions of section 247 TCA are met. If there are any tax avoidance concerns, these should be dealt with by the already very restrictive section 247 TCA relief with its own specific anti-avoidance provisions. The layering over these rules of the ATAD interest limitation, anti-hybrid rules and Ireland's general anti-avoidance provisions contained in sections 811C, 817A, 817B and 817C TCA mean that it is difficult to envisage an abusive scenario which is not already covered in Irish tax legislation.

In many cases, an interest deduction for loans to fund the acquisition of shares that will generate exempt dividends will not be available in all other countries. Those regimes differ significantly from Ireland's as they typically allow for "debt pushdown" or tax consolidation to permit an effective interest deduction within the country. Unless Ireland was to introduce a similar such regime, it should retain a deduction for interest on debt used to acquire shares (subject to ILR, anti-hybrid rules etc).

We have long advocated for a complete restructuring of the Irish interest relief regime and in our view further restriction of interest relief should not be considered in the absence of such a restructure. It is a consistent message when discussing these issues with our clients that Ireland's regime is already more restrictive than most other EU countries. In our view, Ireland should move to a genuine commercial purpose test, subject to the normal restrictions such as transfer pricing, anti-hybrid, interest limitation and general anti-avoidance rules. A group consolidation regime would also simplify the ability to claim interest relief in a group context and is common in other EU countries. Without a consolidation regime, it is necessary to retain a deduction for debt used to acquire shares otherwise it will not be economically viable to use normal commercial third party debt to fund an acquisition of an Irish company. This would be a very negative feature of any tax system and again would mean that Ireland becomes an outlier internationally.

Any attempt to restrict interest relief to loans drawn down for foreign investments and not Irish investments could only comply with EU law if it is focused solely on wholly artificial arrangements. Given the extensive specific and general anti-avoidance rules (in addition to ILR anti-hybrid rules etc.) already available to Irish Revenue to challenge an avoidance transaction it seems unlikely an additional anti-avoidance provision is required for this purpose.

In ***Cadbury Schweppes -v- Commissioners of Inland Revenue***[16] the Court stated in respect of freedom of establishment:

> "*any advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated is subject cannot by itself authorise that Member State to offset that advantage by less favourable tax treatment of the parent company.*"
>
> "*It follows that, in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory*."

There is similar settled case law of the Court in relation to the measures prohibited by Article 63(1) of the Treaty on the Functioning of the European Union ("**TFEU**") such as restrictions on the movement of capital which include measures that discourage non-residents from making investments in a Member State or discourage that Member State's residents from doing so in other States.

In ***European Commission -v- United Kingdom***[17] the Court stated:

> *"...., the free movement of capital may be limited by national legislation only if it is justified by one of the reasons mentioned in Article 65 TFEU or by overriding reasons in the public interest as defined in the Court's case-law, to the extent that there are no harmonising measures at European Union level ensuring the protection of those interests."*
>
> *"A national measure restricting the free movement of capital may thus be justified where it specifically targets wholly artificial arrangements which do not reflect economic reality and whose sole purpose is to avoid the tax normally payable on the profits generated by activities carried out on national territory."*

In summary, in our view no specific restriction for interest on loans to fund investments in respect of which exempt foreign dividends may be paid should be introduced as this is unnecessary and likely to be in contravention of EU law. We would welcome a restructure of the Irish interest relief regime in line with other EU countries and following the introduction of the ILR, anti-hybrid rules etc., a restrictive regime is no longer required.

Question 12

Please outline what in your view the impacts, if any, of participation exemption and/or branch exemption regimes might be on Ireland's Exit Tax rules. Do you foresee any synergies or risks in this space?

Question 13

Please identify how particular design features of the exemption regimes could have positive or negative impacts in this context.

An ATAD compliant exit tax is aligned with a participation exemption noting that all EU countries that have a participation exemption must also have an exit tax regime under ATAD.

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[16] Case C-196/04 - *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* (12 September 2006)

[17] Case C-112/14 - *European Commission -v- United Kingdom* (13 November 2014)

On the basis that both income and gains of a foreign branch should be exempt (on an elective basis), the current exit tax regime may require modification to ensure that accrued gains arising on assets transferred to a branch which is exempt from tax are captured in the exit tax regime. This is included as a proposed design feature in our response to question 7 above.

Question 14

Do you believe that a review and simplification of Schedule 24 could be feasible and sufficient, instead of changing to participation exemption and/or branch exemption regimes? How might this simplification be achieved?

Question 15

What in your view are the relevant considerations in terms of any simplification of Schedule 24?

Question 16

In the event of Ireland moving to participation exemption and/or branch exemption regimes, what simplifications, if any, could be considered for the remaining credit system of double taxation relief - including in respect of foreign-source interest and royalty income and out-of-scope dividend, branch income and capital gains?

For the reasons outlined above Schedule 24 (even if simplified) is not sufficient to deal with concerns around Ireland's lack of competitiveness. However, we would advocate for a simplification of Schedule 24 in addition to the elective participation exemption so that where the option to exempt branch profits or dividends is not exercised, a simplified version of Schedule 24 would be applicable.

We would advocate for a simplified principles based approach to be adopted in Schedule 24 including the following:

1. Applying one dividend credit regime regardless of the residence of the payer entity so that different regimes are not applicable to treaty and non-treaty countries;

2. A single rate of tax on dividends being 12.5% (or 15% where Pillar Two applies to the dividend);

3. For the purpose of Schedule 24 paragraph 9I, allowing taxpayers the option to choose to apply the nominal tax rate of the country in which the profits have been subject to tax for the year in question without the requirement to first calculate the actual credit and then perform a top-up paragraph 9I calculation;

4. Allowing dividends to be attributed to a particular year based on an election rather than the year in respect of which the profits were declared for company law purposes which can give rise to complexities due to differing rules and concepts in foreign corporate law;

5. Removing anomalies associated with dividends paid through intermediate holding companies;

6. Removing complexities around the terms distribution, dividend etc.so that it is clear that all non-capital repatriations are covered;

7. Broadening the scope of Schedule 24 paragraph 9H to ensure all forms of foreign merger can benefit from this provisions; and

8. Removing complexities around differences in timing of branch profits and losses in Ireland and other jurisdictions which results in double taxation.

In addition, a provision similar to section 637 TCA should be included to deal with situations where in principle a credit should be available but due to the technical terms of Schedule 24, this is not clear.

Concerns around the capacity within Government to revise the Schedule 24 rules for those companies electing out of the exemption, should not be a reason to further delay a dividend and branch exemption regime. Instead the exemption could be introduced with effect from 1 January 2023 with the simplification of Schedule 24 with effect from 1 January 2024.

Question 17

Please outline how territorial participation exemption and/or branch exemption regimes could impact on Ireland's Anti-Hybrid rules. Do you foresee any synergies or risks arising from the change?

Question 18

Please identify any specific design features of exemption regimes that could have positive or negative impacts in this context? Please elaborate.

Question 19

Please identify any adaptations to Ireland's Anti-Hybrid rules that should be considered in conjunction with a transition to such exemption regimes.

ATAD compliant anti-hybrid rules are aligned with a participation exemption. We note that all EU countries that already have participation exemption must also have anti-hybrid rules under ATAD and therefore a participation exemption should not create further risks.

Ireland's anti-hybrid rules included a specific provision section 835AB TCA to allow for our worldwide taxation system. This provides that where payments are ignored under a worldwide system of taxation, (otherwise known as "disregarded payments") they should be treated as included so that a technical hybrid mismatch does not occur in circumstances where it should not.

Under an exemption regime, this treatment should continue to apply for branches where the election for a territorial regime is not made in respect of that branch. However, the legislative provisions accompanying the introduction of the territorial regime should confirm that section 835AB TCA should not apply in respect of exempt branches.

Finally, as noted in our response to question 7 above, we propose that the dividend exemption should apply only where the payer has not obtained a tax deduction in respect of the payment and the branch exemption should have a subject to tax requirement both of which requirements align with the anti-hybrid rules.

Question 20

Do you foresee potential impacts, arising from moving to participation exemption and/or branch exemption regimes, for the way in which the two pillar solution is implemented in Irish tax law? Are there any potential synergies or risks with the implementation of the two-pillar solution and such exemption regimes?

As participation exemption regimes are the norm across OECD countries and the EU, we have no concerns around the interaction of the Pillar Two rules and participation exemption regimes.

Indeed, the OECD model Pillar Two rules and the draft EU directive provide that dividends, other than short-term portfolio dividends, are generally excluded for the purpose of the global minimum tax calculation which is consistent with a participation exemption regime. In addition, a permanent establishment is treated as a "constituent entity" for the purpose of calculating the minimum effective tax rate and the model rules and draft directive include provisions for allocating income between the main entity and the permanent establishment.

Accordingly, a failure to exempt branches and introduce a participation exemption for dividends will cause problems as it is out of step with the design of Pillar One and Two.

Question 21

Do you foresee potential impacts, arising from moving to participation exemption and/or branch exemption regimes, for Ireland's tax treaties?

Question 22

Should the renegotiation of Ireland's tax treaties, as respects the Elimination of Double Taxation article, be considered in the event of the enactment of participation exemption and/or branch exemption regimes? Would this be necessary? If so, how might it be feasible to accomplish this in a targeted and efficient manner?

Question 23

Would any amendment of Ireland's worldwide tax system to allow for exemption of foreign dividends, gains or branch income necessitate a review of specific tax treaties in Ireland's network, where previously Ireland's worldwide charge would have ensured taxation of such dividends, gains or branch income? Alternatively, could such taxation be ensured by limiting the scope of any exemptions enacted in domestic law?

It is unlikely that Ireland's double tax agreements will require any substantial amendments following the move to a dividend exemption regime. On the basis that the domestic provisions will limit the charge to tax on dividends and Ireland's treaties provide for double tax relief only against Irish tax charged on the relevant income, profits or gains, it is unlikely that any material amendments to Ireland's double tax agreements would be necessary as a result of the introduction of a participation exemption for dividends. We understand that this was the case when the UK moved to a participation exemption for dividends. Where an exemption is limited by reference to the source of the underlying profits (which we do not propose) the position may be more complex as partial exemption and partial taxation and credit may apply.

Some amendments might be considered in the context of the branch exemption and the specific provisions of each treaty should be reviewed in this regard. However an optional election should ensure that where circumstances arise such that the interaction of a treaty and a branch profits exemption gives rise to unintended consequences, the taxpayer may choose to remain in the current regime.

It is important that existing relieving provisions should be retained in circumstances where an election for a branch or dividend exemption is not made.

Question 24

Do you foresee impacts in relation to the matters identified above or any other matters related to transitional arrangements?

We have set out our comments in respect of transitional arrangements in question 7 above.

Question 25

In your view, what other relevant considerations should be taken into account? You may wish to consider this question in the context of the recent OECD Inclusive Framework Two-Pillar agreement.

We have included our comments on the interaction with the OECD Inclusive Framework Two-Pillar agreement at question 20 above.

Yours faithfully

Arthur Cox LLP

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ARTHUR COX LLP

Appendix 1 - Cross-Border Tax Rules[18]

	Participation Exemption			Tax Treaties	Anti-Tax Avoidance Rules
Country	**Dividend Exemption**	**Capital Gains Exemption**	**Country Limitations**	**Number of Tax Treaties**	**Controlled Foreign Corporation Rules**
Australia	100%	100%	None	45	Yes
Austria	100%	100%	None	89	Yes
Belgium	100%	100%	None	95	Yes
Canada	100%	50%	Countries with a tax treaty or Tax Information Exchange Agreement	96	Yes
Colombia	100%	0%	Applicable to holding companies, no country restrictions	9	Yes
Czech Republic	100%	100%	EU member states and EEA member states or double tax treaty	89	Yes
Denmark	100%	100%	EU member states and EEA member states or double tax treaty	75	Yes
Estonia	100%	100%	EU member states and EEA member states and Switzerland	58	Yes
Finland	100%	100%	EU member states and EEA member states or double tax treaty	76	Yes
Greece	100%	100%	EU Member States	57	Yes
Hungary	100%	100%	None	81	Yes
Iceland	100%	100%	None	45	Yes
Israel	100%	100%	None	58	Yes
Latvia	100%	100%	Black-list countries are excluded	62	Yes
Lithuania	100%	100%	Black-list countries are excluded	54	Yes
Luxembourg	100%	100%	None	83	Yes
Netherlands	100%	100%	None	96	Yes
New Zealand	100%	100%	None	40	Yes
Poland	100%	0%	EU member states and EEA member states and Switzerland	85	Yes
Portugal	100%	100%	Black-list countries are excluded	78	Yes
Slovak Republic	100%	100%	Countries with a tax treaty or Tax Information Exchange Agreement	70	Yes
Sweden	100%	100%	None	81	Yes
Switzerland	100%	100%	None	93	No
Turkey	100%	100%	None	86	Yes
United Kingdom	100%	100%	None	130	Yes
United States	100%	0%	None	66	Yes (Subpart F)
Norway	97%	100%	Black-list countries are excluded	87	Yes
Germany	95%	95%	None	96	Yes
Italy	95%	95%	Black-list countries are excluded	100	Yes
Spain	95%	95%	Black-list countries are excluded	93	Yes
France	95%	88%	Black-list countries are excluded	122	Yes
Slovenia	95%	47.5%	Black-list countries are excluded	59	Yes
Japan	95%	0%	None	70	Yes
Ireland	0%	100%	EU member states and tax treaty countries	73	Yes
Chile	0%	0%	N/A	33	Yes
Korea	0%	0%	N/A	93	Yes
Mexico	0%	0%	N/A	59	Yes

[18] Daniel Bunn and Elke Asen, *International Tax Competitiveness Index 2021*, Tax Foundation