Tax Monitor

TAX

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Brian Daly

Finance Act fails to fully deliver for international sector.

The Finance Act 2006 should have marked a watershed as a nationwide international financial service industry emerges from the IFSC umbrella. Whilst containing some welcome features, it failed to act in a number of key areas and even more disappointingly made unannounced changes which have left many investors wondering what other planks for inward investment policy might disappear overnight.

Let's be clear: the abolition of capital duty and relaxing the leasing ring-fence on the utilisation of leasing capital allowances are positive developments. However the restriction of the remittance basis was disappointing and has certainly caused inward investors to wonder whether the mantra about a stable and consistently positive environment for inward investment is as true today as it has been in the past.

In addition the abolition of gross roll-up for life policies and investment funds has all the hallmarks of an ill-considered and not fully thought through reaction to a domestic problem which has very significant knock-on negative consequences on the vitally important international part of our economy.

This approach to the framing of tax legislation must be corrected or we will pay an economic price. There are understandable pressures in the Department of Finance in having to deal with EU concerns. However, the ease with which the Revenue Commissioners now seem to be able to get Government to put through changes they want without proper time being given to fully consider the broader implications, is a worrying trend which needs to be responded to.

The consultation process which sees the industry making requests for changes has got to be reciprocated with clear indications from Government on areas they see that need to be changed to rectify domestic concerns, and allow the international financial services sector to have an appropriate input into the framing of a response which does not negatively affect their sector. Given the experience of how Government has responded to the Social Partners' representation at the Partnership Talks, perhaps it's time for the critically

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important international financial services sector to have a more clear voice in those discussions.

Welcome measures

Capital duty has been abolished at last. Ireland had become an anomaly amongst the Member States in retaining this duty, whose abolition has for a long time been official EU policy. It really should have gone a long time ago.

The restrictions on the use of leasing capital allowances have been relaxed. This follows lengthy discussions between the Department of Finance and the financial services industry. These discussions procured significant improvements in the drafting of the measure, even after the Bill was originally published. The engagement of the department with the leasing sector and KPMG regarding this problem was excellent and a model of what the relationship between the Financial Services sector and the Public Sector should be.

Certain leasing companies will now be permitted to offset their leasing capital allowances not only against income from the leasing of machinery and plant, but also income from the financing of similar machinery or plant, lease management income in relation to the leasing of such machinery or plant, gains on the disposal of such leased plant, and ancillary activities.

To avail of this widened scope for the offset of capital allowances, it is necessary that at least 90p.c. of the activities of the leasing company should consist of such leasing, financing, lease management, disposals etc and that the activities of the company, or of those parts of the parent group of which it is a member, which are located in treaty territories, should consist wholly or mainly of leasing plant and machinery.

The relaxation of the ring fence would mean that capital allowances on leased plant and machinery, to the extent that they are not required for offset against the income from leasing, may be offset against eg interest income on loans financing the purchase of similar types of plant and machinery. That offset against interest income is only on loans to finance the purchase of plant and machinery of a type similar to that leased by the company. The significance of this restriction is that it limits the possibility of the offset of capital allowances on big ticket items (eg aircraft, rail locomotives) against loans financing small ticket items (eg computing equipment).

Remittance basis

The remittance basis of taxation of expatriate staff was a major element in Ireland's international tax competitiveness. It has been severely damaged in a knee-jerk reaction to trade union concerns relating to the construction industry. In any other country such a fundamental change would have been flagged by the publication of a Green Paper and extensive consultation, in order to determine the best way forward. In Ireland, the damage was done with an over-night announcement and an implacable refusal to take on board reasonable suggestions on alternative approaches which could have largely dealt with the underlying problem without totally eliminating a provision which has produced many benefits for the country.

Funds roll-up

The ending of the gross roll-up regime for funds is an example of the pursuit of a narrow agenda without regard to the wider damage being done to the financial services industry. Nothing about the manner in which this has been done would suggest that the measure has been properly thought through.

The story started a year ago with legislation imposing a charge of tax on a deemed disposal of the investments of funds at the end of a seven year cycle. This was introduced without prior consultation. At the last moment the Minister was prevailed upon to defer the implementation of the section. The Finance Act 2006 has extended the measure to mutual funds, and has brought it into effect with an eight year cycle. It says a lot about the degree of analysis lying behind the measure that the original proposal was one which would not only damage the financial service industry internationally, but would domestically create an uneven playing field as between life assurance products and mutual funds.

Irish based life companies and funds now have an administrative burden placed on them in terms of

identifying which policy and unit-holders attract the new tax, and which (the vast majority in the case of our international financial services industry) do not. Unfortunately, this added layer of administrative cost in a highly competitive sector may well cause companies affected to either close their products to Irish residents entirely, or consider their location.

There is no reason to suppose that direct investors in equities turn over their investments any more frequently than do investors in life policies or funds. The worry that has led to this measure seems petty and misplaced and the potential impact on a financial services industry that is largely international in its focus, damaging and disproportionate.

Irish resident investors in foreign based life policies and funds will also have to account for the tax, but on a self-assessment basis. Hopefully it will not be the case, but it is difficult not to suspect that such Irish resident investors in overseas products will fail to note the passing of each eight year anniversary on a fairly widespread basis. After all, who keeps a diary for eight years ahead? What is the point of setting up a system where inadvertent non compliance is likely to be widespread?

Interest

The existing unilateral exemption from withholding tax on Irish source interest on quoted Eurobonds was available only where the bonds were in bearer form. This has now been extended to registered bonds. This is a welcome development.

Irish withholding tax on interest payments relieved by a patchwork quilt of partial exemptions, and the technical liability to Irish tax by non residents receiving Irish interest, even where no withholding tax is applicable, remains unaddressed despite lengthy discussions on this problem going back over years.

The Finance Act has taken no action on the effective ending of the IFSC exemption from the treatment of interest paid to associated companies resident in non Treaty States by financial service trading companies, as a non deductible distribution subject to dividend withholding tax. This has been under discussion for years, and it had long been foreseen that it needed to be tackled by 31 December 2005. But nothing has been done.

Without changes in these areas, Ireland's ability to sustain a strong base of international treasury operations will be fatally damaged. I think it is time for the international banks to turn the heat up on the government to make changes in this area.

Conclusion

There were thankfully some positive changes in this year's Act, but unfortunately there were too many errors and omissions. We need a much more robust process to properly consider the impact on the critically important international financial services sector of legislative changes designed to solve other issues within the economy. Perhaps it's time for the international financial services sector to be represented more clearly in the Partnership discussions so their views can be even more directly heard within Government. Our recent prosperity seems to be breeding complacency and perhaps it might even be called arrogance. Hopefully we will not have to pay for this later.

Brian Daly is the editor of *Tax Monitor* and a tax partner in KPMG

John Bradley

Expatriates hit.

The ending of the remittance basis of taxation of expatriates, in so far as it applied to employment income from duties in Ireland, requires both employees and employers to urgently consider their situation. Both face potential, difficult to quantify, tax exposures as a result of the hasty curtailment of the remittance basis.

Background

The remittance basis of taxation computes Irish income tax on the income of Irish resident but non-domiciled persons – 'expatriates' – and Irish domiciled persons in their first three years of residence after a lengthy absence, on their Irish and UK source income as it arises, and on other income only to the extent that it is remitted into Ireland. Many expatriates seconded to Ireland by multinationals have foreign employment contracts and foreign pay-points in relation to their salaries etc, and are able to avail of that basis of taxation, thus minimising their Irish tax bills. The regime made it attractive for an expatriate to be seconded to Ireland, and helped minimise the cost to a multinational of sending key executives to Ireland. It was an important part of Ireland's tax package for multinationals.

Apparently arising out of the potential application of this basis of taxation to a recent influx of foreign construction workers, this long-standing relief was withdrawn with effect from 1 January 2006, in so far as it had application to employment income where the duties of the employment were carried out in the State.
The withdrawal of the relief potentially affects employers in that they may face compensation claims from seconded expatriates, and in that they are facing PAYE obligations. It affects many expatriates who find that the basis upon which they were seconded to Ireland has changed overnight, without consultation.

The employer

The PAYE implications of the changes are possibly the most urgent matter which an employer needs to address. Although all payments from 1 January 2006 onwards in respect of 2006 income must be processed through the PAYE system, the Revenue have indicated that employers may postpone the implementation of PAYE until 1 March. PAYE is therefore a very immediate problem.

The PAYE issue will affect not only somebody who is the direct employer of the expatriate, and who is Irish based, but also anybody in Ireland making payments of remuneration on behalf of an employer, and also any Irish based business for whom an expatriate is working, notwithstanding that they are employed by a non-resident employer who does not operate PAYE. In most instances the expatriate will be directly employed by a non-resident company and seconded to work in Ireland for the benefit of another group company. That company is therefore the company which must now gear itself up to account for PAYE, whether or not it is making the salary payments.

The operation of PAYE will require knowledge of what part of the remuneration package relates to Irish duties, something which prima facie will require knowledge of the overall remuneration package. In some cases that information is not normally available to the Irish business and divulging it may raise HR and other issues.

Many individuals affected by the restriction of the remittance basis will have duties both in Ireland and abroad. If that arrangement is continued with, this obliges the employer and the employee to agree on the appropriate apportionment of the remuneration package as between the two types of duties. The Finance Act does not offer guidance as to how that is to be done.

By definition, the employees affected by the new rules are paid from abroad, under a foreign contract of employment. Some such employees are already subject to salary withholding taxes in another jurisdiction. The Finance Act contains no provisions to avoid a double withholding tax situation which would have a severe impact on the employees' cash flow. In some of those cases, where the foreign withholding is in a Treaty State, the double withholding will not necessarily result in double taxation at the end of the day, but it could take a long time to get the necessary tax refunds etc. If the foreign withholding is in a non-Treaty State, then the double withholding could represent effective double taxation.

Going forward

Both employers and employees have an interest in ensuring that the remuneration package of the expatriate is tax efficient, in a global sense. Since the basis on which it was structured has changed, it is probably prudent to take advice on how it can be restructured efficiently.

In the short term employers need to protect themselves against PAYE exposure, and interest on late payments of PAYE by gearing up to apply PAYE.

Expatriates who will continue to avail of the remittance basis on part of their income will need to review their banking arrangements to ensure that in the future what is now Irish taxed income does not get mixed in with foreign source income taxable in Ireland should it be remitted to Ireland.

The tax exposure in Ireland on employer contributions to a foreign pension scheme should be reviewed to see if they come within an exemption which applies where certain criteria are met. A side effect of the restriction of the remittance basis is to potentially bring such pension contributions into charge on an employee, in a manner akin to benefits in kind.

John Bradley is a Tax Partner in KPMG.

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Pat McDaid

Pensions caps

The Finance Act has imposed punitive tax on pension provision in excess of certain limits; capped the maximum tax free lump sum that can be taken from a pension scheme; imposed effective payout requirements on ARFs; but has improved the funding rates permitted by older persons.

Capping pension funds

What might be thought of as a cap on the amount of tax approved pension funds has been introduced in the Finance Act. It is not a formal cap in the sense that it does not forbid funding of pensions beyond a certain limit, nor does it deny tax benefits for that funding. What it does do it to impose punitive taxation on the pension fund and the pensioner, once any benefits crystallise out of a pension fund that has been funded beyond pre-set limits.

To illustrate how the punitive taxation will work, consider a defined contribution scheme where, on the date the employee becomes entitled to a pension, the fund is E1m in excess of the appropriate threshold. A tax charge of E420,000 will be imposed upon the pension fund. That will leave E580,000 of the excess still in the fund, and available to purchase an annuity for the pensioner. That E580,000 net amount will emerge to the pensioner as taxable income, in all probability subjected to a further 42 per cent tax. The E1m excess will have borne an effective tax of approximately 66.36 per cent. This may be compared with the maximum tax liability that can arise in relation to an individual, which (taking levies into account) is 44 per cent.

If the scheme were a defined benefit scheme, a 42 per cent charge would have arisen on the scheme trustees, thus leaving them under-funded to provide the promised benefits. If the under-funding is made good by the employer, that additional contribution would in turn be charged to tax at 42 per cent, and so on.

In practical terms, the alternative to further funding by the employer is a reduction of benefits for the employee, to reflect the fact that part of the scheme assets have been diverted to the Revenue and are no longer available to purchase an annuity. The effective tax rate on the defined benefit scheme, where the employer does not make an additional contribution, is as outlined for a defined contribution scheme.

The limit over which a tax charge will arise on the fund can be one of two figures. The standard threshold is E5m (indexed). However a higher threshold amount is possible where the pension which an individual would have received had he reached normal retirement age on 7 December 2005, when valued at a factor of 20 times the pension, would produce a higher threshold.
The assumption that a person had reached their normal retirement age on 7 December 2005 is an assumption solely about the individual's age and does not change the actual years of service they would have accrued at that date, when determining the pension entitlement they would have had at that date.

If for example, an individual would have been entitled to a pension of E300,000 on 7 December, had they reached normal retirement age on that date, their threshold amount would be E6m, and not the standard threshold amount of E5m. The valuation factor used, of 20, is arbitrary and the resulting threshold amount is not necessarily an accurate reflection of the size of pension funding that in practice would be required to provide the pension benefits in a particular case.

This higher threshold amount, is available only when an election is made by the taxpayer to the Revenue not later than 7 June 2006, or before pension entitlements crystallise if earlier. This deadline for notification can be critical for higher paid executives now approaching retirement, or with substantial accrued pension benefits.

The new arrangements have implications not only for those whose pension fund is at or approximating the new thresholds over which the penal taxation applies. It has implications for the remuneration package of any top executive, in so far as pension arrangements that could ultimately produce a fund in excess of E5m are under consideration, or already exist.

What to do?

Firstly, employers and higher paid executives need to check if their personal threshold limit at 7 December 2005 would be higher than E5m. If so, they have a short timescale in which to serve notification to the Revenue of this fact, or otherwise they will lose the benefit of the higher threshold amount. Failure to make that notification on time could cost approximately 20 per cent of the difference between the standard threshold amount of E5m, and what would have been their higher personal threshold amount. That would be a costly error.

For employers and employees already committed to pension arrangement which seem likely to ultimately produce a fund in excess of the E5m standard threshold limit, there may be a need to renegotiate their remuneration package in a more tax efficient manner. It is possible to come up with innovative and tax efficient approaches, but employers and employees should avoid knee jerk reaction such as "let's look at share options". Such "first come to mind" solutions may not introduce significantly greater efficiency, at least from an income tax viewpoint.

Double taxation

The punitive taxation on a pension fund that exceeds the threshold amount has been perceived to have involved an element of double taxation. That is valid. What is not generally understood is that the basic rules relating to pensions are themselves fundamentally based on a double charge to tax.

In the ordinary way you would have expected that where an employer promises an employee a pension, the employee will be taxed when he receives the pension, but that otherwise it would not be a matter of concern to him. That is not the way the tax law is structured. Where an employee is entitled to a pension on retirement, unless that pension is to be provided through a Revenue approved pension scheme, a double charge to tax will arise. The first charge will arise on the employee as the employer makes payments to an unapproved pension scheme, or will arise to the employee in each year of service where the pension promise is unfunded. When the pension itself is paid out, a further charge to tax will arise. Furthermore, an unapproved pension scheme is itself liable to tax on its income and on its capital gains.

The escape from this peculiar system of double taxation is provided by means of ensuring that the pension funding is through a Revenue approved scheme. In such a case the employee will face a tax charge only when the pension scheme commences to provide benefits to him. And now, under the new rules, a surplus over the threshold amount will on that occasion, effectively again becomes liable to a double charge to tax.

The background approach to pensions, in setting up a scheme predicated on a double charge to tax, but then reducing it to a single charge to tax if it is funded through a Revenue approved scheme, is bizarre. The changes made in the Finance Act betray the symptoms of tinkering with an ill-designed system that was in need of fundamental reform.

ARF payouts

With effect from January 2008, approved retirement funds will be taxed on the assumption that they pay out 3 per cent of their value each year as a pension payment, whether or not they do so. It is understandable that an ARF, since it is created as a form of pension provision, should be required to provide a pension. What is not readily understandable is that an ARF is required to do so regardless of the amount of the fund. If the fund suffers from the fundamental problem of being inadequate, would it not be more sensible to permit it to grow through capital gains and income being rolled up, before beginning to pressurise it into paying out sums as pensions?

The new regime would have made more sense if it applied only to ARFs to the extent they exceeded a certain minimum figure, but this is not what has been done. Furthermore, the new rules take no account of the age of the owner of the ARF. At a time when thinking in the area of pensions is taking account of increased longevity, and the possible need to lengthen the working life, should an ARF be pressurised to commence pension payments from as early (in some cases) as 55 years of age? Would it not have been more sensible to apply the system only once the owner of the ARF arrived at the age of (say) 70 years?

The 3 per cent deemed payout does not apply to an alternative minimum retirement fund (AMRF). It appears to be the view of the Revenue Commissioners that such funds cannot have an initial transfer to them in excess of E63,750. Whether or not such a cap on the size of the fund exists is questionable in terms of the legislation, and would seem even more questionable in terms of policy. A sum of E63,750 is an inadequate safety net in the case of a person moving his pension funds into an ARF (from which they can be withdrawn subject to tax at any time). It is unfortunate that the opportunity was not taken to substantially increase the minimum amount which must be placed in an AMRF, where funds are to be transferred from an approved pension scheme to an ARF.

Overall, the changes in the area of pensions reflect much tinkering, and inadequate analysis.

Pat McDaid is a Tax Partner in KPMG.