# Tax Monitor

TAX

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## Budget 2008

**Brian Daly**

***Against a backdrop of unstable financial and property markets, it was important that the Budget did not create further instability or contribute to inflation. It succeeded in both of these objectives. That said, there were areas where it fell short of what is needed, writes Brian Daly.***

**Certainty prevails**

At the core of a business wish list for any Budget is certainty. Minister Cowen is to be commended in providing this, with a budget which included no changes of an inflationary nature. In the wake of economic slowdown, his decision to continue to roll out the essential National Development Plan, with a budget deficit funded by borrowings, rather than tax hikes, is praiseworthy. But has he done enough?

**Business Tax**

The main corporate tax change was a further increase in the threshold, under which smaller companies have the option to pay preliminary tax based on 100% of the previous year's tax liability, rather than on their forecasted liability. This threshold has increased from €150,000 to €200,000.

While it is heartening to see the Minister acknowledge these concerns, I fail to see the logic of why the Department persists in thinking that it is easier for bigger companies to predict profits accurately when their business is usually more complex, and, particularly in the case of financial institutions, more subject to market fluctuations? It is time to recognise that big businesses do not have crystal balls either and that these rules are fundamentally unfair and significantly increase compliance costs.

Separately, film relief is extended on the current basis until 2012 and we hope for more positive developments in the Finance Bill, to restore competitiveness relative to the UK, following an ongoing review of the relief.

The Minister also extended the status quo in relation to R&D but generally, the lack of new business initiatives is disappointing.

**R&D**

The existing R&D incentive provides for an annual tax credit equal to 20% of incremental expenditure over the 2003 base year. It was given a boost with a further 'freezing' of the 2003 base year until 2013. However, it should never have been designed based on incremental expenditure, thus requiring companies to have ever escalating expenditure in order to benefit. An overhaul of the system to permanently remove the incremental concept would give more certainty and provide a greater stimulant to research activity.

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Budget delivers on VAT

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The Government says our future lies in being a knowledge-based economy. Our R&D regime needs to be at least on a par those of our European neighbours to attract such activity and this is not currently the case.

We need a package of measures including refunds of credits to loss making start up companies, reform of the double tax relief regime relating to royalties from intellectual property and provision for tax deductibility of amortisation of intangibles.

**Employee costs**

The raising of basic tax credits, the widening of the standard rate tax band and the increase in the lower employer PRSI threshold and employee PRSI ceiling were essential to help keep take home pay in line with outgoings, without further erosion of our competitiveness via pay increases. However the increases of approximately 4% do fall slightly short of estimated inflation rates.
The favourable remittance basis regime for expatriates, and people returning to Ireland after several years abroad, has never been available in respect of UK income and gains. Following queries from the European Commission, the Minister is removing this exclusion for UK income from 1 January 2008. This will open up UK investment products to some Irish based individuals, which would previously have been tax inefficient. The Budget announcement does not refer to removal of the exclusion of UK gains and we assume this will be rectified in the Finance Bill.

Likewise the UK Chancellor has announced the extension of the UK remittance regime to Irish source income. This is positive news for Ireland as a location for collective investment vehicles targeting the UK market.

Since the abolition of this regime in respect of employment duties carried on in Ireland in 2006, it is now only of real relevance to investment income and capital gains. Unfortunately, the Minister has not attempted to restore incentives for employment income and has not followed the UK approach to reform by proposing a capped income tax liability on expatriates after they have been resident in the UK for a set period (7 years) and allowing the remittance basis to continue on the balance.

In summary, basic indexation measures have been taken to curb declines in competitiveness due to employment costs. However, the lack of announcement of any plans to reinstate a system which will make Ireland competitive in attracting mobile intellectual capital i.e. some form of targeted remittance basis, is disappointing.

**The Green Agenda**

The initiatives aimed at promoting ‘green’ activity, include:

- Extension of the BES regime to provide easier access for recycling companies.
- Introduction of an excise tax on electricity from 1 October 2008 with exclusions for energy used by households, electricity produced from renewables and combined heat and power generation. This is required by the EU Energy Tax Directive.
- Measures to link Vehicle Registration Tax (‘VRT’) with carbon emissions levels rather than engine capacity from 1 July 2008. This will result in higher VRT rates, than currently, for higher carbon emitting vehicles and lower for ‘greener’ ones. Whereas rates range from 22.5% to 30% currently, depending on engines size, in future rates will vary from 14% to 36% based on emission rates. In theory, this should see the price of greener vehicles fall and that of others rise. The changes will only be relevant to new vehicles purchased, or any vehicles brought into Ireland, after 1 July 2008. The Minister said the change will be broadly revenue neutral. However, surely if the method does actually incentivise people sufficiently, VRT levels should fall?
- Reduction in availability of capital allowances and tax deductions for leasing expenses on business cars with higher carbon emissions (more than 155g/km) and abolition of these allowances and deductions on cars with emission levels of over 191g/km from 1 July 2008.
- Reduction in the VAT rate on supplies used for the agricultural production of bio-fuels to 13.5%.
- Announcement that the forthcoming Commission on Taxation will consider the possible introduction of a carbon tax.
- Announcement that Minister is looking at targeted incentives for business to support the installation of energy efficient equipment.

Such measures were undoubtedly necessary to attempt to meet EU commitments under the Kyoto Protocol, by virtue of which Ireland must reduce carbon emissions to no more than 13% above 1990 levels by 2012. An opportunity is being missed to use tax policy to positively incentivise the development of renewable energy however, such as the introduction of a tax credit type system, as used in the US, that would act as an incentive to financial services companies to put up capital, increasing the amount of expenditure for which the existing corporate tax relief is available etc. Also with reform of stamp duty on property afoot, it is surprising the Minister and his Green party colleagues didn’t look to the UK’s lead in introducing an exemption from stamp duty on new zero-carbon homes up to certain limits.

**Plastic card boost**

The Minister has, at last, reduced the penal stamp duty on credit and debit cards which should encourage more competition in this market, espouse a less cash oriented economy thus reducing financial crime and ease of funding to criminal gangs. Stamp duty on credit cards will be reduced from €40 to €30. Duty on ATM and Debit cards will go from €10 to €5 and on combined ATM/Debit cards, from €20 to €10.

There was no indication however that this will be the start of a process of further reductions and ultimate elimination of this counterproductive stealth tax though Irish banks face growing competition from foreign banks who can supply cards to the Irish market without such duties.

Furthermore the measure was counterbalanced by an acceleration of the payment dates of stamp duty on such cards with a payment on account due from December next year based on 80% of the previous year's liability and a doubling in the charge on cheques/bills of exchange from 15 to 30 cents. The latter is baffling as it will encourage the black economy and reversion to cash based transactions for smaller services where providers cannot provide a card payment facility e.g. elements of the building, repairs trades etc.

**Stamp Duty**

Last but not least, the much longed for 'countercyclical' stamp change that has dominated the news. Whatever the state of the property market, the stamp duty system which applied the higher rates of stamp duty to the entire amount once the price exceeded certain limits was unjustifiable and probably created distortions which were masked by the unusually buoyant market conditions of recent years.

The Minister simplified the system to provide an exemption on the first €125,000 consideration on all purchases with just two rates applying thereafter; 7% on the excess over €125,000 up to a price of €1 million and 9% on any further excess. The reduction of claw-back periods from 5 to 2 years where properties, qualifying for owner-occupier exemptions are rented, reflects the reality of a mobile workforce who may need to relocate for career or personal reasons. However 9% is still an extraordinarily high rate of transaction tax especially for the commercial property market where no reform was announced.

**What he forgot**

As usual, we hold out hope that some issues of a technical nature may be addressed in the Finance Bill. These include the final reforms needed to end the transition from the IFSC/Shannon tax regimes, such as the issues related to payments of interest abroad etc.

Calls for the reversal of the 8 year deemed disposal rules for funds and provision for tax deductibility of interest on tier 1 capital seem to have fallen on deaf ears. The Minister talked about saving for retirement, but ignored calls to review pension provisions introduced in 2006 which penalise those saving for retirement.

There are many broader areas where we campaigned for fresh thinking - widening of the securitisation regime, to include for example, carbon credits, introduction of a participation exemption for foreign dividends and profits from foreign branches, introduction of a venture capital type scheme or other reliefs to encourage much needed entrepreneurialism, including further increases to BES capital raising limits.

Stability is good but may not be enough. As competition for mobile inward investment intensifies, we hope the Minister will not let the Finance Bill pass without resolving well documented issues which are very important for the international financial sector in Ireland.

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**Terry O'Neill**

## Budget delivers on VAT

***The Minister announced the introduction of the new VAT on property regime following an extensive period of consultation. He also made welcome increases to VAT registration thresholds, writes Terry O'Neill.***

**VAT on Property regime**

The principal VAT change announced relates to an overhaul of the VAT on property regime which will take effect on 1 July 2008. The detailed provisions will be included in the forthcoming Finance Bill. We provided a summary of the original proposals in our February edition of Tax Monitor and reviewed their likely effectiveness in the August edition. These fundamental changes will affect the VAT treatment of all commercial property transactions.

**Key Features**

- It is proposed that the VAT treatment of the sale of property will no longer be determined by reference to whether the property has been developed since 1972. Instead, VAT will apply to the sales of 'new' properties which are defined as the first sales taking place within five years of completion of the property, or any further sale within five years of completion where the building has been occupied for less than two years. Sales of other properties will be VAT exempt but with an option to apply VAT at 13.5%, which will be exercisable jointly by the vendor and purchaser.

- The distinction between 'short' and 'long' leases will be removed. All leases (except very long leases akin to a freehold) will be exempt from VAT unless the landlord opts to charge VAT on the lease rents at 21%. It would appear the election will be property specific but there will be consequences where cancellation takes place within

20 years from commencement of the lease. Given that leases are commonplace within groups of companies, it is disquieting that it is now proposed that an election will not be possible where the landlord and tenants are connected parties

- A 'Capital Goods Scheme' is to be introduced which is a complex mechanism for adjusting the initial VAT deduction arising on a property transaction. Depending on the use to which the property is put over the 20 years from acquisition, a party acquiring or developing a property may be required to adjust the initial deduction claimed. The transitional measures mentioned suggest a partial clawback of VAT deducted in the last 20 years under the old rules where the use of the property changes. It was previously proposed that the Capital Goods Scheme operate over a different adjustment period of 10 years in relation to refurbishment costs which would be cumbersome.

This has not been mentioned in the Budget so it remains to be seen whether a common period will prevail.

**Removal of 90% test**

The Budget announcement is also important in that plans to introduce the dreaded '90% test' appear to have been shelved.

Under the original proposals, elections to apply VAT on leases could only be made where a tenant has at least 90% VAT recovery. This was an area causing significant concern in the market because of the difficulties monitoring the VAT status of tenants and sub-tenants. The dropping of this measure should avoid VAT being trapped at the level of landlords leasing to exempt or partially exempt financial services tenants.

However much will depend on the specific provisions dealing with cancellation of elections to apply VAT as VAT exempt financial services companies, who currently pay 13.5% VAT upfront on the capitalised value of their rents, may in future pay 21% VAT on rents charged for the full term of the lease which could potentially substantially increase the VAT cost over the life of a lease of say, 20 years or more. Representations have been made to the Department of Finance and Revenue on the potential adverse impact on the financial services industry and it remains to be seen whether these concerns will be taken on board.

**Achieving its aims?**

As always, we must await the detail in the Finance Bill to better assess whether the new regime will achieve the aims of producing a simple and robust VAT system for property. There have been considerable improvements on original proposals. However, the move to the new regime will inevitably involve new complexities.

**Other VAT measures**

From 1 May 2008, the VAT registration thresholds will be increased from €35,000 to €37,500 for services and from €70,000 to €75,000 for goods which can only be good news.

Anti-avoidance proposals were announced to introduce a 'reverse charge' for VAT supplies made by a subcontractor to a principal contractor in the construction sector from 1 September 2008. These will protect Revenue against any situations of subcontractors charging VAT on invoices and failing to pay these amounts over to Revenue.

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## Is tax on your board's agenda?

**Liam Lynch**

***Liam Lynch comments on the increasing stature of tax in the corporate governance arena and on what this really means for group tax functions.***

**Changes in tax function**

Historically the tax function constituted a tiny component of the accounting and finance department in most organisations, assuming one existed at all. Its primary role? To provide a corporate tax figure to complete the financial accounts and ensure that corporate tax compliance was taken care of, quietly and carefully.

This has changed dramatically in recent years. Due in no small part to a number of corporate scandals, such as Enron, Parmalat etc, tax related matters have started to interest journalists and hit the headlines. Tax management has become the target of sometimes emotional and, arguably, misguided comment about whether companies pay their fair share.

Such developments have forced group tax functions out of their old habitat to join the ranks of management and to seek more formal recognition for their policies and requirements right up to board level.

**Increased demands**

Tax departments now face increased demands from both internal and external stakeholders. In the largest organisations, it is fully accepted that the financial and reputational risks around tax make it a boardroom matter. The concept of performance measurement based on shareholder value, and therefore post-tax results has become more commonplace.

Awareness has increased of the

potential damage that can be done to reputations if a company is perceived to engage in what some might construe as ‘unacceptable’ tax planning - the company may be characterised as ‘high risk’ by tax authorities and branded ‘unethical’ in the media.
At tax authority level there appears to be a trend towards a risk-based approach to identifying non-compliant taxpayers and some larger authorities (such as US, Australia etc) see a lack of board level involvement in setting the tax agenda as tantamount to bad management, if not negligence.

**What this means for the tax function**
In considering a tax risk policy, group tax functions must grapple with questions such as whether to measure business line performance using post-tax or pre-tax measures. The former makes tax cost a reality for front line managers. On the other hand, the use of pre-tax measures avoids encouragement of certain inappropriate behaviour, such as competitive tax planning between different parts of the business, that benefits the individual business unit at the expense of the business as a whole.

In any organisation, the tax function will draw up the detailed implementation rules on tax risk policy but decisions regarding the company’s attitude to tax and the management of associated risks can only be taken at board level. The challenge, of course, is to communicate the relevant parameters effectively to non tax professionals to give them adequate understanding to reach informed decisions.

The tax function must then put appropriate procedures in place to implement the policy, ensuring appropriate sign-offs are obtained for tax planning and structuring activity, that appropriate advice is taken, that issues are communicated quickly to avoid surprises and so on. Such risk policies need to cover the whole array of taxes - corporate tax, indirect taxes, transactional taxes etc When one considers that such work comes at a time of ever-increasing compliance and information reporting requirements from tax authorities, it is no surprise that this is putting significant strain on tax functions.

**The ‘moral’ agenda**
Alongside these developments, a worrying tendency seems to have emerged among external stakeholders to make ‘moral’ judgements about tax planning and to expect companies to manage their tax affairs in a ‘moral’ way. The ‘fairness’ of corporations’ tax policy is frequently questioned by tax authorities, pressure groups and media.

Let’s be clear about this. Tax is a cost to business. As with any other cost, the board members owe their shareholders a duty to manage that cost by the legal means afforded to them. Where a company’s tax philosophy is heavily influenced by a duty to shareholders, the focus should be on responsible management of tax cost. Again the starting point should be board level decisions on how the risk needs to be managed.

It seems to have become fashionable to use terms such as ‘aggressive tax planning’ and ‘unacceptable tax minimisation’ synonymously with ‘tax avoidance’, whilst arguing that such practices demonstrate a lack of morality in tax matters. However there is no agreement on what constitutes morality either within or outside the sphere of tax. We cannot therefore have recourse to such a term in determining whether planning of tax affairs has crossed some illusory line. It is in the interests of some parties that lines are blurred in the perception of the difference between legal tax avoidance and illegal tax evasion. However, we must rely on the rule of law to protect the rights of both taxpayers and exchequers alike. Otherwise we will have to deal with such questions as to whether we should pay tax if it funds something we consider immoral. That is surely something we wish to avoid.

That said, in order to manage reputational risk, companies must reconcile their obligations to shareholders, to manage the bottom line, with public perceptions on the ethical and moral nature of tax planning or tax motivated transactions.
Interestingly a survey carried out by KPMG International in 2005 for the purposes of a paper, Tax in the Boardroom, showed very low appetites for any level of reputational risk. It seems boards recognise that while certain tax planning strategies may contribute to the bottom line and create shareholder value in the short term, they may have the potential to destroy value in the long term if a company’s reputation suffers. To this end, many large groups are developing reputational risk committees of one type or another to opine centrally on whether certain transactions or planning initiatives fit within the group’s acceptable risk profile. They usually have a clear mandate from board level or may even consist of board members.

**The reality**
KPMG published a discussion paper on The Governance of Tax earlier this year which confirmed that tax governance is rising up the board agenda. Progress has been made towards recognising tax as a key issue for boards since the 2005 publication, Tax in the Boardroom. However, as tax is becoming ever more complex, many companies still have a gap between the required level of understanding, and involvement at board level, and that which is needed to ensure that appropriate tax strategy is put in place, and that tax departments are not left exposed.

Another KPMG report, The Rising Tide, published earlier this year, presented survey results which indicated that less than half (48%) of companies have a formal tax risk management strategy, although experience would suggest that tax issues are frequently addressed at board level irrespective of the absence of formal procedures. Even though increased focus on this area has only emerged relatively recently, the majority of those surveyed did report greater scrutiny from CFOs and audit committees, while at the same time having to cope with increased compliance requirements.

The survey gave some insight into increased pressures faced by tax departments worldwide and the fact that many are struggling to communicate their need for additional resource. Most tax departments surveyed still spent the majority of their time on tax return compliance but believed they could offer more value elsewhere such as in the provision of accurate and timely financial reporting, assessment of tax risk, management of tax authority audits, offering strategic advice to the business etc.

**Conclusion**

In many ways, the corporate scandals which raised the profile of tax risk, and that of the teams who manage it, only accorded tax a level of prominence which it has always warranted. Tax needs to be on the agenda for the boards of companies because it is increasingly expected that that is where the policy in this regard is set. At the same time, Revenue authorities need to respect the fact that tax is a cost to business and must be managed as such. The tax department's key responsibilities are to manage that cost, ensure absolute compliance with the tax code and manage the inherent tax risks that exist in all organisations..

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