KPMG

Tax Monitor

TAX

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The Twin Engines of the EU

The first half of 2006 has seen significant action by two of the EU institutions, in the area of tax. The European Court of Justice (ECJ) has given a number of landmark judgements which generally favour tax competition amongst Member States. In contrast, the EU Commission is working away on a number of projects aimed at the harmonisation of tax rules within the community, and the consequent reduction in tax competition.

The ECJ

Cases heard by the ECJ go through a two-part process. The first stage after the hearing is the publication of a draft judgement called the Advocate General's Opinion. This is usually, but not invariably, followed in a subsequent judgement given by the Court. The first half of 2006 has seen a number of important tax cases reaching the stage of the publication of either an opinion, or a final judgement. This represents the end of a process that probably began years ago in the case of each individual case. It is probably something of a coincidence that so many major tax cases have appeared in the first six months.

Many commentators have detected in recent opinions and judgements, an increasing reluctance on the part of the Court to interfere with national sovergnity in the matter of taxation. However, the Court is constrained by its constitutional obligations to enforce the EU treaties. These treaties generally outlaw aspects of national tax systems which are discriminatory or protectionist in their nature. The Court, therefore, has little or no discretion but to strike down such measures.

However, the language it has used in recent cases - in particular in the Marks & Spencer case regarding cross-border losses, and in the Cadbury/Schweppes case dealing with controlled foreign company legislation - has shown an attempt by the Court to minimise the impact of the decision on national tax systems. As a result, some of these judgements have avoided fully exploring the issues and may have to be revisited by the Courts.

Cross-Border Losses

Marks & Spencer claimed group relief in the UK in respect of losses of a French resident subsidiary, which was outside the UK tax net. The domestic law of the UK, as is the case with Ireland, would not have allowed such relief. The Court upheld the taxpayer's contention that such a denial of relief interfered with its freedom of establishment, i.e. its freedom to choose to conduct its

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business in France through a subsidiary rather than through a branch. However, the ruling of the Court limited the entitlement to relief by the parent company and made no reference to relief being available to fellow subsidiaries. That aspect has been left ambiguous, and possibly requiring a further case to clarify it. Furthermore, the Court held that relief had to be provided in the UK only when it could be demonstrated that relief in any other EU Member State was no longer possible.

It did not clarify whether that meant legally impossible, or merely practically impossible. Neither did it clarify whether the normal domestic rules in relation to claiming loss relief - which generally speaking, requires a claim within two years of the end of the year in which the loss is incurred - could be used to defeat a claim, where the impossibility of getting relief abroad became apparent only after that time period of two years had elapsed.

Because of the many ambiguities in the judgement, it is of marginal importance only in increasing the relief actually available to tax payers.

Control Foreign Company Legislation

The Advocate General Opinion in the Cadbury/Schweppes held that controlled foreign company legislation was compatible with EU law provided it had application only to artificial arrangements which involved either the foreign company not carrying on real economic activity in the country in which it was located, or in charging its fellow group members for alleged services that were in reality of no economic significance to those members.

Since that clearly is not what controlled foreign company legislation is aimed at in the UK, the practical effect of the judgement is to largely render UK CFC legislation illegal (and to have been so at all times). Because of the contrived manner in which the opinion arrived at the conclusion - stating that CFC legislation was compliant with the EU law in unrealistic circumstances - it offers the UK the temptation to take minimal action to reform its legislation.

It would not be surprising to find that further cases on CFC legislation will be needed to clarify the legitimate limits to such legislation.

The opinion held that where an overseas subsidiary had the premises, plant and staff commensurate with the extent and complexity of the services it purported to offer, it could be regarded as carrying on bona fide commercial activity in the overseas State, and accordingly (provided the services it provided the group members were of real economic significance to them) to be outside the scope of CFC legislation.

But the case left undecided the position of an overseas subsidiary which outsourced its activities. Each subsidiary has a choice of carrying on its activities through staff employed by it or through agents. The judgment focused only on the situation of the company with staff. If member states attempt to continue to apply CFC legislation to agency situations or to companies which resort to subcontracting , it may be necessary to resort again to the ECJ.

Exit Charges

A recent judgement in the case of a Netherlands individual who emigrated to the UK reinforced the message of a previous ECJ judgement in the de Lasteyrie case which held that many exit charges � charges to CGT imposed on a taxpayer when leaving the tax net of a Member State and moving to another Member State - were contrary to EU law as interfering with freedom of movement of persons, freedom of establishment, and freedom of movement of capital.

The most recent judgment suggests, however, that an exit charge which is confined to a charge on the part of the gain that has arisen during a person's period of residence in a Member State may be lawful in some circumstances. Ireland imposes exit charges on individuals, companies, and on trusts.

The charge in Ireland is not on the gain that arises during residency in Ireland but rather on the gain that has arisen up to the point of departure, even if part of that gain arose prior to a person becoming resident in Ireland.

Foreign Dividends

A number of UK companies challenged the UK 'Franked Investment Income' regime which is similar to the Irish tax treatment of domestic and foreign dividends. Under this regime, dividends from one Irish company to another are tax exempt (apart from surcharge) whereas foreign dividends are fully taxable albeit with credit in some cases for foreign taxes.

The opinion given has held, not surprisingly, that the discriminatory treatment is contrary to EU law. This may open up the prospect of a claim for refund of tax by companies who have suffered tax in Ireland on foreign dividends.

In a separate case concerning cross border dividends (Denkavit) the advocate general has cast doubt on the legality of withholding taxes within the EU on dividend payments , especially where the dividend is tax exempt in the country in which it is received , as it would seem dividends received by a corporate in Ireland from another EU state should be.

Reclaiming Tax

The many tax cases that appear before the ECJ are not taken by taxpayers out of concern for the public good. They are taken to defend themselves against an immediate tax charge, or to seek refund of taxes paid in the past, possibly illegally. All of the cases described above raise the potential, not only in the UK and elsewhere, but also in Ireland, for claims for refund of tax. Even the CFC case has such an implication in Ireland, notwithstanding that we have no formal CFC legislation.

We do, however, have legislation that can attribute to individuals, the income of companies or trusts resident abroad, including in the EU. Aspects of that legislation may, by implication, be unlawful.

However, the ability to claim refunds of tax is not without limits. In a recent case involving an Italian local authority tax, the Court noted that if all of the tax that had been levied in Italy had to be refunded, the impact on Italian national finances would be catastrophic. It also noted that the tax was of such importance that it was essential that Italy be able to put a replacement tax (meeting EU treaty requirements) in place before the existing tax could cease to operate.

For all of these reasons, it was proposed that Italy would be allowed until the end of 2006 to come up with a replacement tax, and in the meantime could continue with the illegal tax. It is also proposed that only those who had claimed refunds up to the date of the issue of the Advocate General's opinion should be entitled to a refund. This was an attempt to balance the need to give taxpayers an incentive to challenge illegal taxes, while ensuring that the result is not to bankrupt the Member States.

This rule is not applied in every case and will be applied only in respect of a tax that was levied in good faith (i.e. without reasonable knowledge that it was illegal) and where the consequences of refunds would seriously undermine the finances of the State.

Nonetheless, it emphasises the importance of acting early and putting in protective claims for repayment of tax, where a taxpayer believes that a domestic tax (whether in this State or in another EU Member State where the taxpayer is exposed to tax) is illegal. Generally, the prospect of getting a refund will be maximised if the claim is made prior to the issue of the Advocate General opinion.

This does not necessarily mean that the taxpayer has to be the first one to claim the refund, and has to be the one who takes the case before the ECJ. If taxpayers take heed of the issues being appealed at the ECJ, there is usually plenty of time in which to put in a protective claim for a refund if a similar issue arises in Ireland.

The Commission

The Commission is acting on a number of fronts to promote tax harmonisation.

Its flagship project is the CCCTB � the Common Consolidated Corporate Tax Base. This is an attempt to produce a single set of rules for determining taxable profits for a trading company, regardless of where in Europe it carries on its activities.

The idea is that a company would file in one location only, pay its tax there, and that the revenues would be shared out amongst the States in which it generates profits, under some pre-determined criteria.

Ireland is opposed to this proposal, which would undermine its tax competitiveness, not least because the criteria for revenue sharing would be likely to favour other Member States, in cases where multinationals are located in Ireland.

The Commission realise that there is little or no prospect of it becoming a mandatory tax system across Europe but are hoping that it will be adopted, on a voluntary basis, by a significant number of Member States.

As Paul McGowan, Tax Partner in KPMG, pointed out in an article in Finance Dublin, the project faces mammoth technical difficulties and an early resolution is not to be expected. The approach being adopted is to draft tax rules from scratch, rather than identifying what is common to the tax systems of the 25 Member States, and using that as a starting point.

The EU are re-examining rules relating to 'place of supply' and are attempting to devise a 'one-stop shop' proposal which would enable the taxpayer making supplies in many Member States to meet all VAT applications in one Member State only. This has echoes of the CCCTB Project in corporation tax.

Since VAT compliance obligations are more burdensome than corporation tax obligations, it makes a bit more sense in the area of VAT. However, the need of Member States to protect their domestic source of finance will, in this case, again prove an obstacle to reaching agreement.

The Commission are also resurrecting a study of VAT as it applies to financial services. VAT can represent a major cost to financial service companies, and can be an obstacle to outsourcing and to the rational development of their businesses. The obstacle to the application of VAT in a straightforward way to financial services and insurance is primarily the definition of 'turnover'. Even if the Commission come up with a solution that would make sense to the financial services industry, it will have to come up also with a solution which does not involve significant loss of tax revenues to Member States.

It may prove very difficult to satisfy the needs not only of the financial services industries but also of the Member States' tax needs. The financial services industry will need to watch these developments very carefully.

The EU is pursuing a coordinated European approach for the design, the implementation, and the evaluation of research and development tax incentives. This does not appear to be an attempt to impose a 'one size fits all' model for R&D tax incentives. Instead, the Commission are proposing to produce a document setting out the constraints of community law in terms of State aids, and to identify the best practices at present in use amongst Member States in promoting research and development.

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Nurturing Smaller Businesses

The report of the Small Business Forum has analysed the position of small and growing businesses in Ireland, and made recommendations for government measures to assist the sector. The analysis and recommendations echo the findings of a report produced by KPMG for the Inland Revenue in the UK.

Small Business Forum

The Small Business Forum was set up by the Minister for Enterprise, Trade & Employment and commenced work in September 2005. It delivered its report in April 2006. It was chaired by Joe Macri, Managing Director of Microsoft Ireland. The speed with which the report was produced, and the clarity of its analysis and recommendations show what can be done when government chooses to consult the private sector, something which it does far too little.

Small Business

The report found that 97% of businesses operating in Ireland today employ fewer than 50 people - which is taken to be the benchmark for 'small'. A quarter of a million small businesses in Ireland employ 770,000 people in total, which represents more than half of the total private sector, non-agricultural work force.

The breakdown of the work force over sectors is interesting.

- Small Business 39%
- Medium/Large Business 34%
- Public Services 17%
- Agriculture 6%
- Unemployed 4%

This is not dissimilar from the findings of the KPMG report in relation to the UK. There, the report identified a total of 4,162,477 businesses, of which 3,064,891 consisted of self-employed individuals. In other words, 72% of businesses were self-employed individuals. A further 23% were micro-businesses with less than ten employees. Only 0.2% of businesses in the UK have 250 employees or more.

When job creation receives media publicity, it is usually in terms of a ministerial announcement that 200 or 300 jobs have been 'created' in this or that town. The analysis above would suggest that there is an unheralded, almost unseen, but more important job growth in process all over the country, consisting of individuals taking up self-employment, setting up their own businesses, and perhaps employing one or two others. Such new enterprises on their own are not, of course, significant. The figures suggest that, in total, they matter more than the 'big job announcement' projects do.

Regulation

The forum recommended a special regulatory impact analysis over a seven year period of all existing regulations impacting on small business, in the areas of taxation, health & safety, and employment with a view to reducing the burden of compliance. It also recommended that exemptions for small businesses be more widely applied in the area of regulation, and that a risk-based approach to regulatory implementation and enforcement to be adopted.

Specific areas were identified in the context of tax. The turnover threshold for VAT exemption, and the threshold for the cash basis of accounting for VAT and non-retail businesses, were both the subject of a recommendation for significant increases. The forum also recommended that where a previous year's tax liability was less than €100,000, the business should be entitled to base its pre-year end preliminary tax payment on its prior year tax figure.

The recommendation regarding preliminary tax is arguably excessively modest. In previous issues of KPMG's Tax Monitor, attention was drawn to this feature of the tax system as iniquitous and illogical. Even a very large business cannot be expected to accurately compute its tax liability five weeks (in some cases, two months) ahead of year end. Yet, that is what the law requires of it. This system is unjust to all business, and not merely small business.

The report carried out by KPMG for the UK Revenue highlighted the impact of the cost to compliance with tax obligations on small businesses. The report calculated that the total cost of complying with tax obligations (quite apart from paying tax itself) in the UK amounted to Stg£5,100 million. Of that, Stg£3,168 million was borne by the self-employed and by businesses employing than ten employees.

In contrast, the bulk of all taxes are actually paid by businesses with 250 or more employees. It is evident that the burden of tax compliance falls more heavily on small businesses than it does on large, having regard to the relative tax take from each sector. This points to the need to focus enquiry on how to reduce compliance costs for smaller businesses.

The UK report also produced evidence arising from interviews, that the perceived complexity of the tax system and of the burdens which it imposed as a business got larger, deterred businesses from growing. Due to fear of facing PAYE and Social Insurance obligations, self-employed people have been reluctant to take on new employees.

Very small businesses were reluctant to grow to the point where their turnover would exceed the low VAT registration thresholds. Due to lack of familiarity with overseas VAT requirements, businesses were reluctant to seek overseas customers.

These findings suggest that entrepreneurship, the creation of new businesses, and the growth of smaller business, would be encouraged if they had relatively greater freedom from tax administration obligations (as opposed to taxation itself). Our tax system is heavily dependent on collection of tax by the private sector, e.g. PAYE, PRSI, VAT and withholding tax on interest, etc. That may save the government costs in terms of Revenue salaries, etc.

However, if it deters businesses from being set up, or from growing, it does so at a huge cost to the economy. It might be sensible to grant an exemption to new businesses from all such obligations in (say) the first five years of their existence, as well as significantly increasing (as the forum has suggested in quite modest terms) the thresholds for registration for the various taxes.

Another interesting finding of the KPMG report, again based on interviews, was that there was a widespread anxiety amongst taxpayers to be tax compliant. It was accompanied by a huge fear that no matter what the tax payer does, should a Revenue audit occur, the taxpayer would be found to be non-compliant and suffer potentially large financial consequences. This 'fear factor' was found to be an important deterrent to setting up in business. That the fear has a certain basis in reality was illustrated by the fact that the survey identified no less than 2,692 separate potential obligations which could be imposed upon a taxpayer by the tax code! These are supported by no less than 279 Revenue forms.

Most of these obligations and forms will never impact on a taxpayer throughout his or her life. The existence of such a dizzying mass of potential obligations, most of which the taxpayer he or is unaware of, create a climate of uncertainty and obscurity that breeds fear and deters enterprise.

There can be little doubt that a large part of the 2,692 separate obligations could be scrapped from the tax code without any significant impact on tax take, and that the national Revenues would not suffer greatly if a bonfire were made of most of the 279 Revenue forms.

The KPMG report found that the largest single cost of meeting with Revenue requirements was the cost of information retrieval. This amounted to 38% of the internal costs involved. It arises because the Revenue require information of a type, and in a form, not normally generated for financial accounting or management information purposes.

As a result, special accounting systems have to be created, or information has to be reanalysed, to meet Revenue requirements. This cost could be minimised if those requirements more closely fell into line with the information that might be expected to be routinely generated for an accounting system.

Changes in tax rules are another major source of cost and irritation. Annually, there are trifling changes, frequently mere tinkering, in tax rules that require businesses to make changes in software, and reacquaint themselves with new rules, often on short notice.

It seems reasonably clear that the cost to business of administering the tax system would be minimised by reducing the frequency of change in the system; by aligning information needs of the Revenue more closely to those that an accounting system would normally produce; and by aligning the computation of a tax liability more closely with accounting profits.

The complexity of the system, and the deterrent fear which it creates, could be reduced by pruning away the vast majority of the over 2,900 separate obligations, so as to retain only those that really matter, that arise frequently, and with which a business might reasonably be expected to acquaint itself.

The disincentives for economic development caused by the burden of administering the tax system could be reduced if smaller businesses (e.g. those with less than ten employees) were permanently excluded from the bulk of tax obligations (other than that of paying their own taxes!) for some initial period (say), five years after being formed.

Other Recommendations

The Forum recommended that BES be extended until at least 2013, and that the limits on the amount of BES based finance of the company might raise should be increased, as well as the limit of relief for individual investors. It also recommended similar changes in the Seed Capital Scheme.

The Seed Capital Scheme is of considerable importance in helping an individual move from being an employee to being self-employed, or even to becoming an employer. It enables one to obtain a refund of past taxes to help finance one's new business.

BES allows capital to be raised on a tax efficient basis. However, insofar as the capital is raised from third parties, and outside the immediate family, there are necessarily administrative costs involved in the issue of a prospectus, etc. These costs can be disproportionately high where the capital raised is small.

For that reason, the tight limit imposed on the total capital that the company can raise under BES greatly reduces the attractions of BES in the financing of the business. Now that we are entering into a higher interest rate environment than we have experience for the last several years, it is important that BES be revitalised. The cap on the amount of finance should be significantly raised.

The Forum rightly identifies the fact that research and development tax credits are not very relevant to small business. The tax credit scheme is focused on innovative, original research. This is likely to be of limited relevance to a new business and beyond the resources of a new business.

The Forum has suggested that instead, new businesses should be provided with innovation vouchers or knowledge acquisition grants. This would more directly meet the real needs of small business, which is to increase their access to existing cutting edge technology, and to existing sources of knowledge.

The Forum have correctly identified locally authority charges - both user charges, developer levies, and conventional 'rates' - as an increasing burden on business. Business appears to be a soft target for local authorities. Levies on business can appear to be more attractive than the pursuit of greater efficiency, or the proper application of 'user pay' charges for local authority services.

Lets Hope for Action

It is too easy for the government to put a report in the drawer and forget about it. Ministers should recall the large role played by reports, such as the Culleton Report, in creating our present economic prosperity. Reports such as the Small Business Forum Report represent one of those rare opportunities that the government has to hear the voice of those with practical experience in wealth creation, job creation, and in running businesses. Ministers should ensure that the report is moved to the top of the agenda of all government departments. Those who took part in the forum and Joe Macri, its chairman, are to be congratulated on an excellent report produced in a timely fashion.