Ernst & Young Tax Services

4 February 2005
Issue 3 – 05

TAX ALERT

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Disclaimer

Finance Bill, 2005

2005 Finance Bill published

On Thursday, 3 February 2005, the Department of Finance published the 2005 Finance Bill. The Bill now proceeds to Committee and Report stages, where additional amendments may be tabled. It is likely to become law sometime in mid-March. In preparing this overview, Ernst & Young Tax Services have highlighted the most significant measures included in the Bill. Further developments will be closely monitored and tax alerts issued to clients on any significant amendments to the Bill.

International Financial Reporting Standards (IFRS)

With effect for accounting periods beginning on or after 1 January 2005, all listed companies in the European Union (EU) must prepare consolidated financial statements in accordance with IFRS (previously known as International Accounting Standards). While consolidated accounts are generally irrelevant for Irish tax purposes, companies may prepare individual entity accounts in accordance with IFRS. Given that tax is computed on the basis of individual company accounts, any move to prepare accounts under IFRS at company level will have tax implications. The Finance Bill contains a number of provisions to facilitate a move to IFRS.

IFRS rules are broadly similar to the existing accounting rules. However, some fundamental differences exist, including:

- the increased use of fair value measurement (rather than cost), particularly in the financial services sector and for financial instruments such as interest rate hedges;
- the greater use of discounting techniques;
- more capitalisation of costs that may have been expensed previously, e.g. development costs;
- more recognition of specific types of intangible assets;
- the treatment of actuarial differences on defined benefit schemes;
- the recognition of share options as an expense of the employer;
- a prohibition on the use of the closing rate to translate foreign operations and the introduction of a new option to present results in any currency;
- new rules for accounting for foreign currency forward contracts;
- the splitting of certain bonds into separate debt and equity components;
- more extensive accounting disclosures.

The Finance Bill provides that, as a general rule, tax computations must be prepared in accordance with generally accepted accounting practice (whether or not this is Irish standards or IFRS) unless there is a statutory basis for a divergence. In this regard, the Bill specifies how certain specific transactions are to be dealt with from a corporation tax viewpoint. For example, no tax deduction is to be given to an employer for any expense recognised in connection with the grant of share options to employees. Under IFRS, companies will also be required to bring unrealised gains and losses into the charge to corporation tax, a situation which previously in practice only applied to certain cases with the agreement of the Revenue.

The Finance Bill also contains anti-avoidance provisions where not all companies in a group prepare accounts under IFRS. Complex transitional measures are introduced to ensure that income does not fall out of charge on the changeover to IFRS or that income is not taxed twice. Any untaxed income (or unrelieved expenditure) will generally be taxed/relieved over a 5-year period, commencing with the first accounting period for which IFRS is adopted.

One impact of the move to align the tax treatment of a transaction with its accounting treatment is that companies will need to identify non-statutory differences between the tax and accounting treatment of a particular transaction (irrespective of whether or not the company is moving to IFRS). Such a divergence may not be permissible going forward. Companies will also need to identify the financial accounting implications of any move to IFRS on a timely basis to ensure that the potential tax implications of such a move (and the accounting treatment thereof) are considered in advance.

Ernst & Young will issue a more detailed tax alert on the implications of these provisions in due course.

Financial Services

Pension Tax Rules and EU Requirements

In accordance with the EU Pensions Directive, a number of amendments have been made to the treatment of Revenue-approved occupational pension schemes, Retirement Annuity Contracts (RACs) and Personal Retirement Savings Accounts (PRSAs). These include:

- From 1 January 2005, occupational pension schemes based in other EU Member States can now be provided to Irish employers/employees as long as the same approval conditions are satisfied. Similarly, and effective from the same date, the requirement that a Retirement Annuity Contract needs to be established in Ireland has been removed.
- A new scheme has been introduced allowing relief for contributions paid by migrant workers now working in Ireland who wish to continue participating in a pre-existing 'overseas pension plan' (i.e. a pension in another EU Member State).
- Provision has also been made for the situation where a retirement fund is established in Ireland with contributions made by undertakings located in other EU Member States. In qualifying circumstances, such a fund will be exempt from Irish income tax and capital gains tax.

Common Contractual Funds

The 2003 Finance Act introduced the concept of the Common Contractual Fund (CCF) to Irish tax legislation. The CCF facilitates the pooling of pension assets in a tax-efficient manner. At the same time, it is intended to address the inefficiencies of maintaining multiple pension schemes by creating a single vehicle for all these schemes to pool their assets. Reporting and dealing costs should decrease, and tax treaty access should be improved.

The existing CCF legislation was limited in that it only applied to Undertakings for Collective Investment in Transferable Securities (UCITS). Primary legislation is to be introduced to extend the scope to non-UCITS. The 2005 Finance Bill amends the legislation to accommodate this. Essentially all CCFs will be tax transparent provided the units are beneficially owned by persons other than individuals. There will also be an exemption from DIRT, bringing it in line with other investment undertakings. In addition, certain reporting requirements will have to be met.

Headquarter and Holding Company Regime

One of the major Irish tax developments in 2004 was the introduction and subsequent EU approval of the Irish holding company regime. EU approval hinged on certain changes being made to the original legislation. The 2005 Finance Bill provides for these changes as promised, with effect from 2 February 2004.

For previous coverage of this issue, see the following Ernst & Young publications: Tax Alert: Irish Headquarter and Holding Company regime now in force and Brochure: Headquarter and Holding Company Regime Brochure

EU Directives

The benefits of the EU Interest and Royalties Directive and the Parent Subsidiaries Directive are to be extended to Switzerland.

In relation to the EU Savings Directive, the 2005 Finance Bill provides for the start date to be revised to 1 July 2005 and the first reporting period to be from 1 July to 31 December 2005. The due date for filing the first return with the Revenue Commissioners remains at 31 March 2006.

Limited Partnerships

The 2005 Finance Bill provides for legislative changes in relation to the treatment of individuals in foreign partnerships or similar structures. This is to ensure that the definition of limited partner is extended to non-active partners in such structures. This measure will apply in respect of claims for relief (for example, capital allowances) made for the income tax year 2005 and subsequent years.

Life Assurance Exit Tax

An anti-avoidance provision has been introduced to counter products designed to avoid the 23% exit tax. The new provision is aimed at certain unit-linked investment policies, which allow the policyholder to avoid the exit tax by either reinvesting the policy value at the end of the investment period without encashing the policy or by switching between funds.

The new provision will essentially result in an exit tax being imposed at the end of a fixed term life policy (where an early encashment penalty applies throughout the term of policy) and in a non fixed term life policy (where a policyholder, at their discretion, switches funds after 5 years). In particular, switching between funds was a key advantage that life products had over certain other investment products. Thus, this provision is likely to cause much debate between the life assurance industry and the Department of Finance over the coming weeks.

In addition, the provision is, in effect, retrospective since it applies to policies that have already been issued where there is switching between funds or where a fixed term policy ends on or after 3 February 2005.

Interest Relief

Many Irish companies and individuals that borrow money from banks for certain prescribed purposes (such as to buy interests in companies or partnerships) obtain a tax deduction, as a 'charge on income', for interest paid. The 2005 Finance Bill extends the relief range in respect of loans from all banks carrying on business in the EU and not just in Ireland, as heretofore.

Encashment Tax

Financial institutions will welcome the removal from the encashment tax deduction obligation of instances where they are only acting in the clearing of foreign interest and dividend cheques and not as the collecting agent.

Dividend Withholding Tax

The 2005 Finance Bill amends the Dividend Withholding Tax (DWT) legislation to exempt two further categories of persons from DWT on dividends received from Irish resident companies. Personal Retirement Savings Accounts (PRSAs) will no longer suffer DWT on distributions received by the PRSA Administrator, provided the Administrator has completed a relevant declaration. An exempt unit trust, whose unitholders are Revenue-approved charities and pension schemes, shall also be exempt from DWT, provided the unit trust has completed a relevant declaration.

Leasing

The leasing sector will welcome the provision that leasing losses incurred in a leasing trade by a company which is a member of a group may be offset against income of a leasing trade carried on by another company which is a member of the same group.

Stock Lending and Repo Transaction

Currently, stocklending and stock sale-and-repurchase (repo) transactions are exempt from stamp duty provided the initial sale and buy back has been completed within a 6-month period. With effect from the passing of the 2005 Finance Act, this time limit will be extended to 12 months.

Revenue Powers — Life Assurance Companies

As expected, the 2005 Finance Bill introduces a provision to facilitate the Revenue's investigation of 'single premium policies'. The Revenue will have the power to inspect the records of life assurance companies in relation to the sales of single premium policies. The information from such inspections may then be used by the Revenue to seek High Court Orders compelling the life assurance companies to provide historical details of such single premium policy investments. Depending on the scope of the Court Orders, compliance is likely to prove time-consuming and expensive. The information obtained is expected to lead to a Revenue investigation of policy-holders along the lines of the recent 'offshore assets and bogus non-resident deposit accounts' investigations. Indeed, the Minister for Finance has already indicated that a voluntary disclosure scheme will be introduced to encourage individuals who may have tax issues arising from such investments to regularise their affairs. Individuals who qualify to make voluntary disclosures under the scheme are likely to be charged reduced penalties and avoid publication of their settlement on the quarterly tax defaulters' list.

Capital and Indirect Taxes

Capital Taxes

Stamp Duty Anti-avoidance

Anti-avoidance provisions have been included to counteract a situation where two or more purchasers acquire separate interests in a dwelling house or apartment under separate conveyances and thereby reduce or eliminate the stamp duty arising.

For example, if two individuals who were not first time purchasers acquired a dwelling house valued at €600,000 under one conveyance, stamp duty at the rate of 7.5% applied. If they acquired a half interest in the property each under two separate conveyances, consideration of €300,000 was paid for each interest and therefore stamp duty of 5% was paid on each conveyance. The new provision provides that where more than one conveyance is executed within 12 months of another and each conveyance transfers a separate interest in the same dwelling house or apartment, the transfers shall be treated as a series of transactions and stamp duty shall be payable on the total market value of the dwelling house or apartment.

First Time House Buyers

The 2005 Finance Bill confirms the reduction in stamp duty rates for first time purchasers introduced in the 2005 Budget.

Exemption for Switching of Financial Cards

The Bill also confirms the Budget provision that an exemption from a second charge to stamp duty will apply where an individual switches credit, laser or ATM cards during the year. The change in relation to credit cards and charge cards will take effect from 2 April 2005 and the change in relation to ATM, laser cards and combined cards will take effect from 1 January 2006.

Double Tax Relief

The 2005 Finance Bill extends the existing provision which grants a credit for foreign tax paid in respect of property situate in that foreign territory. The new provision will allow a credit for foreign tax paid in respect of property situate in *any* territory. There are some other minor technical changes to the CAT legislation.

Indirect Taxes

The 2005 Finance Bill contains a number of measures not previously mentioned in the Minister's Budget.

Mineral Oil Tax

In order to comply with Ireland's outstanding requirements under the EU Energy Tax Directive, the Minister has introduced the EU minimum tax rates for auto LPG, non-auto LPG and heavy fuel oil. This has resulted in small excise increases for the relevant products. In the case of auto LPG, the increase will be around 1.5 cent per litre and only a fraction of 1 cent per litre in the case of non-auto LPG and heavy fuel oil. These increases are effective from 1 April 2005.

New Tax on Coal

Another measure required under the EU Energy Tax Directive is the introduction of a minimum rate of excise duty on coal. The new rate of tax on coal is €4.18 per tonne for business use and €8.36 for non-business use. However, the scope of this new tax will be very limited since all the reliefs allowable under the Directive will be availed of. Consequently, coal used, for example, in electricity generation, by households, by charities, in agriculture or by energy-intensive businesses entering into environmental agreements will not be covered by the new tax. The intended date of introduction of this new tax will be 1 July 2005.

Alcohol Products Tax

Under current legislation, there is provision for the Revenue to permanently close licensed premises or registered clubs where the licensee or the secretary of the club has been convicted of certain Alcohol Products Tax (APT) offences. It appears that this provision has not been applied in practice. The 2005 Finance Bill proposes to replace this provision with a new measure of 'temporary closure' of such premises. It is our view that the introduction of this less onerous penalty will more likely result in a wider application of the law in this area.

Tobacco Products Tax

Under current legislation, the charging of Tobacco Products Tax (TPT) applies at the time of the issue of the tax stamps to the manufacturer, as opposed to the time when the tobacco products are released for consumption. In July 2004, Ireland received a 'Reasoned Opinion from the European Commission' objecting to this procedure. Accordingly, a provision is now being included in the 2005 Finance Bill to bring the current charging regime into line with EU rules. This will be achieved by introducing a deferred payment regime for the tobacco manufacturing sector, thereby producing a cash-flow benefit.

VAT on property

A new Revenue power has been proposed, authorising the Revenue to appoint a person to value a property in cases where the value, for VAT purposes, is in doubt. No further details have been provided on this proposal, such as the circumstances in which such a valuation will be requested or the qualification and independence of the valuer.

Other Measures

Revenue powers

The list of prosecutable Revenue offences has been expanded to create a new offence of aiding or facilitating tax evasion.

Failure to deduct Relevant Contracts Tax, or to pay over-deducted Relevant Contracts Tax on time, to the Collector-General is also considered an offence.

An offence committed by a company was previously attributable to a company officer by virtue of that person’s consent or connivance. It will now also be attributed to neglect on that person’s part. This will be of particular significance in respect of offences such as failure to deduct/remit taxes such as PAYE/PRSI, VAT, DIRT or Relevant Contracts Tax.

In relation to the publication of Revenue settlements, there is a welcome increase in the publication threshold above which a tax settlement may be published — from €12,700 to €30,000. Unfortunately, the increased threshold only relates to taxes falling due after 31 December 2004. There is also a provision that the threshold will be increased every 5 years by reference to the Consumer Price Index.

In the area of penalties, the Bill proposes legislation to reduce the maximum 200% tax geared penalty in respect of fraudulent filing/non-filing of tax returns down to a maximum 100% tax geared penalty.

Interest on overdue tax

With effect from 1 April 2005, interest on overdue tax will be subject to a rate of 0.0273% per day (just under 10% per annum). Previously, the rate of interest applying on overdue tax was 0.0322% per day (approximately 11.75% per annum).

However, underpayments of fiduciary taxes (i.e. VAT, PAYE and PRSI) will remain at the daily rate of 0.0322%. Given that the interest is not tax deductible, a 10% rate would still appear to be excessive. Notwithstanding the latter, prior to the 2005 Finance Bill, a 2% rate per month of interest could apply where the underpayment arose due to fraud or neglect by the taxpayer. This punitive rate has been abolished for the year of assessment 2005 and subsequent years and accounting periods beginning on or after 1 January 2005.

Share options

Current legislation imposes a charge to income tax on gains realised on the exercise of a share option. In circumstances where the option was granted prior to the option holder becoming tax resident in Ireland, the option gain escaped a charge to Irish income tax. The 2005 Finance Bill extends the charging provisions by imposing an income tax charge on gains arising on the exercise of an option by an individual who is tax resident in Ireland at the date of exercise, but not tax resident at the date of grant. This amendment only applies to options granted on or after 3 February 2005.

The interaction of this amendment, and the acceptance by the Organisation for Economic Co-Operation and Development (OECD) of a recent report on the taxation of share options, will permit Ireland to impose income tax on a gain realised by the exercise of share options on a time apportionment basis by reference to the period of time the option holder exercised their employment in Ireland.

The Department of Finance has advised that further details and clarification will be contained in Guidelines to be published by the Revenue Commissioners shortly.

Employee Benefit Schemes

With effect from 3 February 2005, an employer will not be entitled to claim a corporate tax expense deduction for contributions made for and on behalf of its employees or directors to an employee benefit scheme until such contributions become liable to income tax in the hands of its employees or directors. Contributions for this purpose include cash or assets.

However, this provision does not include contributions to approved employee share schemes, certain accident benefit schemes or approved pension plans. These contributions will continue to be deductible in the year the contribution is made.

Employee Share Ownership Trust

Any payment made to a beneficiary of an Employee Share Ownership Trust (ESOT) out of dividend income received by the trustees in respect of securities held within the ESOT, to the extent that the dividend income exceeds the aggregate of the cost of those securities and expenses, will be subject to dividend withholding tax (DWT). This is applicable where there is an associated Approved Profit Sharing Scheme.

Income Tax on EU Deposit Interest for individuals

For the 2005 tax year of assessment and subsequent years, individuals who are Irish tax resident and in receipt of deposit interest from institutions in other EU countries will pay income tax at the standard rate, previously their marginal rate. This is on the proviso that the income tax due is discharged by the tax return filing deadline.

Relief for Investment in Films

The requirement that at least 75% of the work on the production of a qualifying film must be carried out in Ireland is being removed. This is in line with the recent European Commission approval for the film relief provisions. The Revenue will be allowed to give approval for financial arrangements involving countries other than EU territories or Double Tax Treaty partners in limited circumstances.

Business Expansion Scheme

The Finance Act, 2004 amended the Business Expansion Scheme (BES) and Seed Capital Relief (SCS) legislation to essentially extend these schemes until 31 December 2006 and increase the company limit to €1m. However, these amendments were subject to a Commencement Order being signed by the Minister for Finance. This order was eventually signed in November 2004, but was subject to changes required by the European Commission. The 2005 Finance Bill amends the legislation to incorporate these changes: the primary changes are that a company cannot raise more than €750k in any 6-month period, it must not constitute a ‘firm in difficulty’ for the purposes of the *Community Guidelines on State Aid*, trading operations carried on in the coal industry or in the steel and ship-building sectors do not qualify for these schemes, and the company must be a micro, small or medium-sized enterprise within the meaning of Annex I to Commission Regulation (EC) No. 364/2004.

Hotel Capital Allowances

Most noticeable of the changes in this area is the deeming of hostels and guesthouses to be buildings in use for the trade of hotel-keeping provided they are registered with Fáilte Ireland. This change impacts on expenditure incurred from 3 February 2005 and the write-off period is over 25 years. However, prior to 3 February 2005 expenditure on the construction of hostels and guesthouses may qualify under the existing legislation without the registration requirement. In addition, a registration requirement has also been introduced for hotels in respect of expenditure from 3 February 2005. This requirement will not impact on hotels that qualified for the 7-year write-off in respect of expenditure incurred up to 31 July 2006, under the transitional relief introduced by the Finance Act, 2004.

Holiday camps will also now need to be registered with Fáilte Ireland in order to qualify for capital allowances.

Close Companies Cash Extraction Mechanisms

The anti-avoidance Section 817 Taxes Consolidation Act, 1997 will be strengthened to counteract the effect of certain structures being put in place to arrange the tax-efficient extraction of funds by shareholders of closely held companies. In effect gains on certain capital payments will now be subject to income tax as opposed to capital gains tax. The provisions apply to such payments on or after 3 February 2005.

Manufacturing relief

The 2005 Finance Bill addresses an anomaly in the manufacturing relief formula. It is now provided that companies with accounting periods ending on or after 3 February 2005 must calculate the relief on the basis that certain charges, losses and group relief are no longer taken into account.