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Tax Monitor

TAX

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Pensions and the tax system

Ireland has gone from widespread concern that its citizens were not making adequate private provision for pensions to concern that tax reliefs for pension provision were too generous and were being 'abused'. As this pendulum of concern has swung, the tax treatment of pensions has become ever more complex and, arguably, irrational.

What changes are proposed?
The State and pensions
Before describing the current mess of a system, it is well to remind ourselves why the State has a legitimate interest in pensions.

- Pensions promised by an employer are as much a legitimate business expense of the period when the employee is working as are wages and on first principles should be a tax deductible expense of the employer over that period. But the pension itself would, on first principles, yield tax only when paid. So there is a large timing mismatch between the deduction for the employer and the tax revenue from the pensioner. This is inherent in the nature of pensions. It is in no sense some special form of tax relief.

- The State wishes to ensure that as few as possible citizens become a charge on the State in their old age or when otherwise unable to work.

- Pension funds are important buyers of government stocks and thus financiers of the State deficits. As can be seen, the interest of the State in pensions is legitimate. But the scope of its interest in the matter is also limited as set out above and does not seem to require it to interfere in pensions matters as widely as it does does at present.

The tax grip on pensions
The basic tax rules that shape the pensions system are so bizarre that they are difficult to believe. But they apply only if a pension is provided for other than through "an approved pension scheme" i.e. one which meets Revenue rules. Thus the basic rules are rarely encountered in practice since almost all schemes are "approved pension schemes" but those basic rules are what ensures that pension schemes are tightly controlled by the Revenue.

Those basic rules deny an employer a deduction for the cost of pension funding; tax the employee for any funding made by his employer annually while he is in employment; tax the employee during his employment on the notional funding cost where the employer does not fund a scheme but has promised a pension; tax the income and gains of the pension fund; and then tax the pension when it is paid out.

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In effect there is triple taxation of any pension scheme that is not Revenue approved.

Approved pension schemes
An approved pension scheme escapes the penal triple taxation described above and additionally attracts three

forms of tax relief. Broadly speaking about a quarter of the pension fund can be taken by the pensioner as a tax free lump sum subject to a cap; and the income and capital gains of the pension scheme are tax free. Employees and self employed persons can get income tax relief for personal contributions to a scheme. These are the only features of the tax system that can fairly be called tax reliefs but this fact is usually obscured by counting as a tax relief the right of an employer to deduct their contribution to a scheme - notwithstanding that it is merely a normal business expense that should be deductible on first principles. This distortion helps hugely inflate the reported "tax cost" of pensions provision in the private sector.

First steps at "reform"

Over the last decade or so, attempts were made in a piece meal fashion to address perceived shortcomings in this messy system.

The "annuity trap" whereby most of the pension pot had to be invested in the purchase of an annuity on a date that was rigidly fixed often resulted in annuities being purchased in market conditions that made no economic sense. This increased costs all round to no benefit to anyone. It also limited the capital that an individual pensioner could control and bequeath to the tax free lump sum. This was addressed for the self employed, some directors only, and for employee contributions to a scheme by allowing for the fund to be transferred to an ARF (approved retirement fund) free of the obligation to purchase an annuity. This was not available in respect of employer financed pension funds for the most part.

Protection against mismanagement of the ARF, or excessive early withdrawals from it, which might cause the pensioner to become dependent on the State later, was built in by requiring that part of the fund be in a separate AMRF which could not be accessed until age 75. But the amount required to be kept in this fund was patently inadequate from the beginning and is itself open to suffering investment losses. Subsequently minimum withdrawals in the form of a pension were imposed on the ARF without any regard to whether or not the fund was adequate for long term support or whether or not the ARF holder was still earning and funding a pension scheme.

PRSAs (personal retirement savings accounts) were introduced as a form of pension scheme that was personal to the individual rather than to linked to a specific employer. They were readily portable between employers and between employment and self employment. Oddly, their rules were drafted so as to be less attractive than other approved schemes.

As the concern moved from promotion of individual provision of pensions to the alleged tax cost to the State of such provision, limits were introduced on the amount of the tax free lump sum; on the total amount of a pensions fund; and on the amount of an annual pension contribution that an employee or self employed person could make.

Some of these measures were drafted in a way that favoured civil servants and politicians in respect of their generous pension schemes and impacted primarily on the private sector.

The way forward?

On a clean sheet of paper it is easy to see what the State involvement in pensions might look like, having regard to its legitimate concerns. But our sheet of paper is not clean. We have a long standing complex system in place which goes beyond legitimate State concerns and does not even address those concerns successfully.

The challenge is to move that system in the right direction without injustice to those caught in it at present – both in the private sector and in the public sector.

The Commission on Taxation have had a difficult task in this area and their report will make interesting reading.

Brian Daly is head of KPMG's Financial Services Practice and Adrian Crawford is tax partner at KPMG.

New Penalty Regime for VAT

Niall Campbell

A number of complex changes were recently introduced to the penalty regime for tax. The changes are of particular interest in the area of VAT as VAT is a transaction based tax and so a single error that has become systemised and continues over a period of years or months can lead to very significant costs and exposures for a business.

Some points to keep in mind…

The main aim of the legislation is to put on a statutory footing the provisions in relation to penalties previously contained in the non-statutory Code of Practice for Revenue Auditors. However, the new legislation differs in a number of important areas from the previous Code of Practice with the result that the consequences of underpaying VAT, whether innocently or intentionally, have never been more severe. With the cost, both financially and to business reputation, of getting it wrong on the rise it is critical for any business with operations in Ireland that the new regime is understood and, in particular, that appropriate action is taken in the event of any errors being identified or on notification of a Revenue audit.

Statutory Basis for Mitigation of Tax Geared Penalties

Under previous legislation the penalty for mitigating underpaid VAT was 100 p.c. of the VAT underpaid. However,

Revenue has for many years under the Code of Practice concessionally allowed this penalty to be substantially mitigated based on the nature of the offence, whether a disclosure had been made and whether the taxpayer co-operated with Revenue. However, there was no statutory basis for this mitigation. New legislation puts this mitigation of penalties on a statutory footing as shown in the table below:

Changes from the old Code of Practice

While the new legislation broadly follows the old Code of Practice there are a number of important changes to be aware of.

Disclosure

- The ability to make a verbal voluntary disclosure to mitigate penalties and avoid potential publication as a tax defaulter is now gone. To qualify for non-publication and penalty mitigation the disclosure to Revenue must now be in writing and accompanied by payment of tax and interest (but not penalties).
- It's not all bad news. The provisions bring a welcome change to what was commonly referred to as the three strikes rule. The old Code of Practice allowed a maximum of three qualifying disclosures (with reduced mitigation each time). In contrast, the new provisions allow (potentially) unlimited qualifying disclosures/mitigation provided they occur at least five years apart. Where a second qualifying disclosure is made within a 5-year period the level of mitigation will be reduced.

Court Proceedings

- The Irish Revenue can activate a new "closure" mechanism in cases where agreement on penalties cannot be reached between the Revenue and the taxpayer i.e. if a penalty is not agreed and paid by the taxpayer within 30 days, it may referred to either the District, Circuit or High Court depending on the quantum of penalty. One important point to note is that the courts do not include the Appeal Commissioners. Proceedings must be held in open court making it perhaps less enticing for business to pursue this option.
- Where a taxpayer is found by a Court to be liable to pay a penalty, that penalty may be collected and recovered in the same way as tax is collected and recovered.

Flexibility

- The old Code of Practice provided greater flexibility in determining the category of default. Under the previous Code of Practice the 15 p.c. threshold was only a general guidance and did not automatically result in an underpayment being categorised in this category. This is especially important in VAT where, as it is a transaction tax, the application of the incorrect VAT rate (even as a completely innocent error) could result in an underpayment greater than 15 p.c. Under the new legislation, an underpayment is deemed to be in the category of "careless behaviour with significant consequences" if the underpayment exceeds 15% of the tax, with a result that penalties incurred by the taxpayer will be automatically higher.

Some other points worthy of note…

- While mitigation of penalties has been written into legislation many of the reliefs currently relied upon by taxpayers (such as "No loss of Revenue" for VAT) are only set out in the Code of Practice. Revenue have confirmed that there is no change to the position in relation to "no loss of revenue" cases.
- A range of fixed penalties have been brought up to date and standardised and the amounts of such penalties (which have not been changed in many years) have been increased.

Revenue audits

Significant and complex changes have been introduced into the Irish tax penalty regime and we are already seeing in practice these new changes being enforced during Revenue audits. They also mark a significant change in the environment and approach being taken by the Irish Tax Authorities. For any business with operations in Ireland it is critical that the new penalty regime, and its implications, are understood.

Niall Campbell is a VAT partner at *KPMG*.

Groundbreaking rulings in the EU for Investment and Pension Funds

Anna Scally

In January of this year, the Dutch tax authorities advised KPMG that they would refund tax withheld at source on dividends paid to pension funds established in other EU member states. The refund relates to tax withheld in the period 2003 to 2006. The refund claim was taken by KPMG on behalf of 75 UK pension funds and on its own will result in a refund of approximately €100 million. Separately, the European Court of Justice (ECJ) has recently issued its eagerly awaited decision in Aberdeen Property Fininvest Alpha Oy.

Go Zone legislation in the United States: What qualifies?

These decisions are significant and should make it easier for Irish funds to attempt similar refund exercises where they have suffered withholding tax in the EU. Irish funds must ask themselves some very important questions - Have we suffered withholding tax in the EU in the past, which may be refundable? Indeed, are we suffering tax within the EU that we shouldn't be? If so, what can we do about it?

What happened in the Netherlands?

The basis for the Dutch decision is to be found in EU case law including the Fokus Bank and Denkavit cases, which came before the Court of the European Free Trade Agreement and the ECJ respectively.

The Fokus Bank case considered Norwegian tax rules. These treated dividend payments to shareholders resident in other EU/EEA states less favourably than dividend payments to Norwegian shareholders. The Court ruled that the Norwegian tax rules contravened one of the fundamental freedoms enshrined in European law (free movement of capital). This discriminatory treatment could have had the effect of deterring companies established in another Member States from investing their capital in Norway.

The Denkavit case concerned the French withholding tax rules on outbound dividends and their compatibility with the EC Treaty and the freedom of establishment contained therein.

The France-Netherlands double taxation treaty allowed France to levy a withholding tax on dividends paid to residents of the Netherlands. It allowed the Netherlands to tax the dividends with a credit being given for the French withholding tax. However, because under Dutch law foreign source dividends were exempt from taxation, a tax credit was of no consequence. No withholding tax would have been levied on a payment made by a French subsidiary to its French parent.

As Denkavit in the Netherlands had been treated less favourably than a French resident parent company in a similar position, it brought a claim to the ECJ, disputing the compatibility of French Rules with the freedom of establishment principle contained within the EC Treaty. The court held that this represented discrimination by the French authorities between French parent companies and Dutch parent companies.

What happened in Aberdeen?

The decision in the Aberdeen case was given by the ECJ on 18 June of this year.

Until recently, dividend payments from one Finnish company to another Finnish company were generally exempt from tax (there were exceptions) in Finland. Dividend payments to a foreign company, however, were subject to withholding tax.

The EU Parent Subsidiary Directive allows such payments to be made without withholding tax if the recipient is a company established in another EU Member State that holds the minimum participation and is mentioned in the Annex to the Directive. However, the Parent Subsidiary Directive did not apply in the case in question.

Aberdeen is a wholly owned subsidiary of a Luxembourg SICAV, an open ended investment vehicle. It requested an exemption from Finnish withholding tax on dividend payments made to the SICAV, but the Finnish tax authorities declined this request.

Referring to its previous decisions, the ECJ held that if a Member State has chosen to eliminate the taxation of dividends in the hands of resident shareholders, it must apply the same treatment to non-resident shareholders. Since Finland exempted resident companies from taxation on dividends, levying a withholding tax on dividends paid to a Luxembourg SICAV constituted a restriction on the freedom of establishment concept within the EU treaty. In this case the court outlined certain arguments that were and were not relevant in determining whether or not a discrimination occurred and these may be helpful in looking at specific claims which have yet to be made.

It should also be noted that a restriction can be contrary to the EU treaty but may still be justified in certain instances. For example, if the restriction serves only to deny advantages arising because of the application of wholly artificial arrangements or it concerns other matters in the public interest, then the restriction will be allowed stand. The Court held that none of these instances applied in Aberdeen.

What is the opportunity for Irish funds?

These cases highlight the potential possibility of claiming refunds of tax withheld in other EU Member States from income arising in those states. The Dutch cases mentioned earlier are of relevance to pension funds in the Netherlands and beyond and Aberdeen extends the opportunity to Investment funds. Opportunities may exist in both the EU Member States concerned with the specific cases and in other countries where similar withholding tax issues arise. Specifically opportunities may exist where withholding tax has been suffered on dividends received by Irish funds, where dividends paid to domestic pension and investment funds would have been exempt from such tax.

Irish pension and investment funds should review their positions and ask themselves the following questions – Have we suffered EU withholding tax in the past. Is there an opportunity to recover it? Are we currently suffering withholding tax? If so, why so and why aren't we doing something about it?

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