

Tax Monitor

TAX

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Obama's tax proposals

The eagerly-awaited proposals of the Obama Administration for changes to the US tax treatment of

the offshore profits of US multinationals were announced in outline on 4 May, and subsequently elaborated on in the US Treasury's 'Green Book' or quasi Finance Bill published a week later. They have had a rather mixed reception both in the United States and overseas.

What changes are proposed?

Seen from an Irish perspective, the most important proposals published by the Obama team are:

- change entity classification rules to limit use of "check the box" as a means of avoiding the USA taxation of passive income of overseas affiliates
- remove right to deduction in USA for expenses related to overseas investment other than R&D expenditure
- calculate foreign tax credits on an international pool basis rather than on a per item basis

There are other proposals of little significance from an Irish viewpoint. All the proposals are in mere outline, lacking in detail, and open to major amendment (and even scrapping) as they undergo the legislative process. In

the USA the President may propose, but Congress makes the decisions. It is also common for the Congress to initiate new proposals, so there is no certainty that what is now on the table is all that may become legislation. Indeed there is even some suggestion that a reduction in the US Federal Corporate Tax rate (currently 35%) might even be on the cards. The fact that non-US (including Irish) multinationals are significant employers in the United States has not featured strongly in the debate so far.

Check the box

In a very simplified and broad brush way the USA tax system could be described as one which taxes USA registered corporations on their world wide income (including dividends from foreign registered subsidiaries paid from foreign income) as it arises; taxes USA registered corporations on the world wide passive income of foreign registered affiliates; and taxes foreign registered corporations on their USA source income.

For bona fide commercial reasons a USA multinational may need to arrange cross border payments between its foreign subsidiaries for matters such as use in one State of intellectual assets (IAs) held by a fellow group member in another State. Examples can include patent royalties, lease rentals, interest payments or dividends.

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Such payments also facilitate a USA multinational in minimising foreign taxes, e.g. by placing IAs or financing in low tax jurisdictions and charging high tax jurisdictions for its use.

USA tax law allows one or more foreign affiliates of a USA multinational to elect to be treated solely for USA tax purposes as one corporation thus transforming for USA tax purposes payments between them into mere cash flows within a single company and ensuring that the payments do not attract USA tax as passive income. This election is called 'check the box'.

The present form of the Obama proposal is to limit the right to check the box to corporations registered in the same State.

The good news is that deferral will continue. A US multinational which currently qualifies for the deferral of US taxes on the profits of its Irish subsidiary will continue to be entitled to that treatment. The profits will be taxed in Ireland as before and will be subject to US taxation only if, and to the extent that, they are repatriated to the United States. So far, so good.

What are the possible results of a change in this area?

The first possibility is that taxpayers will leave their structures unchanged with the result that the passive income is currently taxed in the United States. This would appear to make sense only where the US tax rate is lower than the rate applicable to the CFC which is making the interest, lease or royalty payments.

The second is that the structure is unwound with the result that the local corporation tax liability of the active CFC is increased. This may be good news for non-US tax authorities but does not lead to any increase in US tax revenues.

The third is a possible shifting of the active business of non-US subsidiaries from CFCs in relatively high-tax jurisdictions (where currently the local corporation tax liability can be reduced without a corresponding increase in US tax liabilities) to lower-tax jurisdictions such as Ireland. In other words where a royalty structure is being used companies may be required to put all of the related intangible assets and

"principal" operations (employees, functions and risks) into a single jurisdiction. The recent Irish Finance Act provision introducing tax relief for capital expenditure on intangible assets generally is welcome and timely. Our old rules were arguably medieval and the Finance Act attempts to bring us into line with most other modern tax regimes.

Ownership of intangible assets in the Cayman Islands, Bermuda etc would no longer be viable in most cases where 'check-the-box' is being relied upon to avoid taxation in the USA of the passive income. That said, the "Green Book" appears to row back from the initial announcement in this area by stating that 'check-the-box' might continue for wholly owned subsidiaries incorporated in the same jurisdiction as their parent.

It is difficult to see that this change will result in a substantial increase in US tax revenues, although the US Administration have projected that it will raise \$86 Billion over a 10 year period! It is possible that what is contemplated is a change in mindset on the part of US multinationals so that, confronted with higher non-US tax bills arising from this proposed change, the thought might be to put the marginal dollar of investment into the United States rather than offshore.

Limitation on expense deduction

The second proposed change is a denial of current US tax deductions for expenses (such as interest) referable to the generation of profits offshore which qualify for deferral. The thought is that the US tax deduction for any such expenses will not be allowed until the related foreign income is repatriated to the United States and taxed there. An exception is proposed for deductions for research and experimentation 'because of the positive spillover impacts of those investments on the US economy'.

There are suggestions now that the deferral will be amended so as to be confined to interest only. Thus it would

not really impact on non-leveraged groups, although it is worth noting that US debt interest would be allocated to offshore profits on a formula basis and not by reference to the actual use to which the debt was put.

Pooled tax credits

The third proposal is to amend the foreign tax credit rules. As noted earlier, a US company taking a dividend from a CFC, the profits of which have qualified for deferral, pays US tax on the dividend income and takes credit against that liability for foreign taxes paid. The US tax liability will be substantially reduced or entirely eliminated where the dividends are paid from a high-tax subsidiary while the US tax liability will be significant on receipt of a dividend from a low-tax subsidiary.

Under this proposal, the foreign tax credit would be 'based on the amount of total foreign tax the taxpayer actually pays and on its total foreign earnings'. An earlier proposal provided that the credit would be calculated in effect as if all foreign subsidiaries of a taxpayer were a single entity, preventing a taxpayer from maximising the credit by repatriating only high-taxed foreign income. One would assume that any changes in this area will be subject to the provisions of applicable double tax treaties although one should note that the United States has previous form in unilaterally seeking to override treaty provisions.

The Irish perspective

Ireland is concerned with the possible impact of these proposals on US-sourced FDI. It is probably a truism that anything which creates uncertainty as to the long-term tax treatment of investment decisions can only be unhelpful. Having been a destination of choice for US investment, Ireland has justifiable grounds for concern.

A specific concern which Ireland must address is the name-checking of Ireland (together with Bermuda and the Netherlands) in the Obama

Administration initial press release. It is not stated that Ireland is a tax haven but the positioning of the reference in the press release (immediately after a reference to 83 of the 100 largest US corporations having subsidiaries 'in tax havens' and to one office address in the Cayman Islands housing 18,857 corporations) is very unhelpful and unfair.

Ireland is not a tax haven and must continue to push that message at every opportunity. If there may have been a sense in the past that one should let sleeping dogs lie, that time has now surely passed. A country, such as Ireland, which is a founding Member State of the OECD (which has been running a very high-profile campaign against tax havens), which is a long-standing EU Member State, which has in excess of 50 double tax treaties (higher-tax countries tend not to sign double tax treaties with tax havens), which complies fully with all exchange of information protocols, which collects billions of euro in taxes from the corporate sector and which has fully acceded to the EU Arbitration Convention on the resolution of cross-border tax disputes has nothing to hide in this area.

On the positive side, Ireland offers investors (whether from Ireland, the United States or elsewhere) an attractive package which includes, but is certainly not limited to, a relatively simple and very transparent corporate tax regime. Whether or not the proposed changes are enacted in their current form, US multinationals which seek profitably to do business with the 95% of the world's population found beyond US borders will conclude that, for compelling commercial reasons, they need to establish business structures outside the United States. Once that key decision has been made on non-tax business grounds, Ireland will continue to have a very compelling case for attracting its share of the foreign investment dollar. Indeed, certain of the proposed changes, by making it more difficult for US

multinationals to reduce their tax bills in higher-tax countries outside the United States, may make it interesting for US multinationals to increase rather than reduce their commitment to Ireland.

The decision by the IDA to devote resources to monitoring the impact of the Obama tax proposals on Ireland's ability to continue to attract inward investment to Ireland from the US is very welcome. From an Irish point of view, it would be extremely important to continue to monitor the evolution of the proposals as they go through the House and the Senate and for companies who are potentially impacted by the proposals to seek as far as possible to try and influence the evolution of them in a manner which will hopefully allow Ireland to continue to be an attractive location for US multinationals to base high quality jobs in Ireland.

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The annual VAT recovery rate adjustment - an ever present feature of the Irish summer



Niall Campbell

It's that time of year again. As we enter our (so called) Summer months our thoughts are turned to longer evenings, soggy picnics and of course, the annual VAT recovery rate adjustment. For all partially VAT exempt businesses with a December year end the deadline is 19th July or 23rd July for ROS filers.

Some points to keep in mind...

While performing a VAT recovery rate calculation, it should be borne in mind that the legislation governing the means by which it is to be done is very limited. It merely states that the rate should "correctly reflect" the use to which their costs are put and also have regard to the full range of the business activities. As VAT is a self-assessment tax it is for taxpayers to decide what is the most reasonable way of recovering VAT related to the portion of the business which is VATable. The following points should therefore be borne in mind:

- There are a variety of methods and practices which may be used to calculate VAT recovery rates and which vary from sector to sector. That said, a business is not obliged to operate a particular methodology just because it is the industry norm, particularly where it can be shown that it is not appropriate in the specific circumstances.
- While a revenue based VAT recovery method is the most common it may not always reflect your business's activities in the most accurate way. A more appropriate method may be one based on other factors – such as the number of capital values, number of transactions or proportion of staff time spent on particular areas of the business.
- The more VAT is at stake the more complex the methodology can be.
- Once an appropriate methodology is agreed with Revenue it should be applied consistently from year to year, unless there is a change in business profile.
- A business is "strictly speaking" required to directly attribute costs to either its VATable or VAT exempt supplies and only apply the recovery rate to general overhead expenses. However depending on the materiality, Revenue may agree to applying the general overhead recovery rate to some or all of the business costs if it can be demonstrated that it would be

administratively burdensome to analyse each individual invoice and that the net result is not distortionary.

- Failure to carry out the annual adjustment could be a costly mistake as Revenue may impose interest and penalties, together with an assessment for VAT over-recovered, through the use of an incorrect VAT recovery rate methodology. This cost can be further compounded where errors are replicated over the 4 year look back period.

It's not all bad news...

- The annual adjustment brings the potential for additional VAT refunds and cash flow should your recovery rate increase from the previous year. If your business is likely to see an increase in its recovery rate it would be best to make this adjustment at the earliest possible time to benefit from the VAT refund arising.
- The calculated recovery rate may be rounded up to the nearest whole number. By way of an example, if a business has a recovery rate of 15.3%, this can be rounded up to 16%, which could inevitably provide a significant additional VAT recovery for the business.
- By ensuring that the methodology adopted is sufficiently robust and applied consistently from year to year the process will be easier to administer.
- Carrying out the annual adjustment should ensure that the business has no nasty surprises year on year.

Conclusion

For most partially VAT exempt businesses the annual VAT recovery rate adjustment must be completed by 18th July (23rd July for ROS filers). While this process can take some time, it is important that it is done to ensure that no exposures are left in the business and also to ensure that the maximum VAT recovery entitlement is

claimed as soon as possible. If you haven't done it yet, now's the time to get going before it's too late.

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Anna Scally

In a welcome move, the Finance Act introduces capital allowances for capital expenditure incurred by companies on certain intangible assets. Anna Scally outlines how it operates and what improvements might be sought in due course.

Go Zone legislation in the United States: What qualifies?

Companies carrying on a trade will be entitled to claim a tax write-off for the capital cost of acquiring 'Specified Intangible Assets'.

Specified intangible assets, as defined for the purposes of the relief, are intangible assets, as construed in accordance with generally accepted accounting practice and are listed below:

- Any patent, registered design, design right or invention
- Any trade mark, trade name, trade dress, brand, brand name, domain name, service mark or publishing title
- Any copyright or related right within the meaning of the Copyright and Related Rights Act 2000
- Certain supplementary protection certificates for medicinal products

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- Certain supplementary protection certificates for plant protection products
- Certain plant breeders' rights
- Know-how, generally related to manufacturing or processing
- Any authorisation required in order to sell a medicine or product of any design, formula, process or invention for the purpose it was intended
- Any rights derived from research, prior to authorisation, on the effects of items covered directly above
- Any licences in respect of an intangible asset referred to above
- Any "non-Irish" rights similar to those outlined above
- Goodwill to the extent that it is directly attributable to the items set out above

While the list of what qualifies is quite reasonable, it is not exhaustive and may need to be refined in subsequent Finance Acts.

For example, the type of know-how that qualifies is limited. It is limited to know-how generated, in a manufacturing, processing, agricultural, forestry, fishing or mining context! Know-how might also be a vital competitive advantage and relevant intangible asset in a service business too. This type of know-how does not appear to fall within the scope of the provisions at present. Goodwill, only qualifies to the extent it can be directly attributed to another one of the items included in the list of "Specified Intangible Assets". It would have been preferable to see a broader definition for goodwill in the legislation but this might be developed in due course.

In addition, in order to qualify, specified intangible assets must firstly be intangible assets construed in accordance with Generally Accepted Accounting Practice. Under IFRS, it is possible that what was previously

understood to be goodwill may not be so regarded. Rather a separate intangible asset may be created. If that asset is not included in the specific listing, then the regime will not apply to it. One would hope that there is scope to refine the definition in future Finance Acts and Revenue guidance notes.

How does it work?

Companies carrying on a trade will be entitled to claim a tax write-off for the capital cost of acquiring specified intangible assets. The tax write-off will be available over the accounting life of the asset concerned in line with the depreciation or amortisation for accounts purposes. Alternatively, a company can elect to take the tax write-off over a 15-year period.

Where a specified intangible asset is held for more than 15 years, there will generally be no clawback of the capital allowances granted on a disposal of that asset (excluding certain sales to connected companies). The Act contains no change to the capital allowances regime for computer software. Therefore capital expenditure thereon continues to qualify for allowances over an 8-year period. The existing provisions relating to the acquisition of patent rights and certain know-how are being discontinued for companies. The new specified intangible asset provisions will now apply to these assets. Transitional arrangements will apply.

The new provisions introduce certain restrictions and anti-avoidance measures. Specifically, they introduce absolute restrictions on the level of the tax deductions available for capital allowances on specified intangible assets and certain related interest costs. They also include restrictions on the ability to claim the relief against unrelated income. The legislation requires activities that relate to managing, developing or exploiting specified intangible assets on which allowances have been claimed, to be regarded as a separate trading activity. This also applies where activities

comprise the sale of goods or services that derive the greater part of their value from such assets. The relief for capital allowances and certain interest costs is restricted to 80% of the related income, excluding such allowances and interest.

The restriction applies first in respect of the capital allowances to be claimed on the specified intangible assets and then, if necessary, to the interest expense incurred. Unused allowances or interest can be carried forward and treated as an allowance or as a qualifying interest expense in succeeding accounting periods. Similar restrictions are introduced in relation to the tax deductibility of interest incurred on borrowings used to invest in a company which acquires the specified intangible assets. This restriction applies where the interest relief being claimed exceeds any amount of interest or certain dividends received from the company that acquires the specified intangible assets. In those circumstances, the amount of interest that can be deducted as a charge is limited to the interest that would have been deductible had the company which acquired the specified intangible assets incurred the relevant interest expense directly. The new provisions will not apply in circumstances where the expenditure incurred on the asset exceeds an arm's length amount or where the expenditure by the company was not incurred wholly and exclusively for bona fide commercial reasons but rather as a means of reducing or avoiding a liability to tax.

Revenue will have power to appoint an independent expert to opine on whether the price paid for the intangible asset exceeds an arm's length valuation in circumstances where the asset is acquired from a connected company or individual. Before disclosing information to an independent expert, Revenue must advise the company. Where the company demonstrates to Revenue's satisfaction that the disclosure of information could prejudice the company's trade, no disclosure will be

made to the expert. Similar provisions exist in connection with the R&D credit and as such Revenue have experience in deferring to third party experts. One word that recurs throughout the previous paragraphs is "restriction". While it is acknowledged that certain restrictions may be appropriate, restrictions introduce complications and uncertainty. Complications and uncertainty can deter investment. If we are serious about becoming a Smart Economy, and about winning highly mobile investment from abroad, it may be appropriate to reconsider some of the restrictions introduced.

Conclusion

While the relief is not yet as fully formed as it might be, it is very welcome. Indeed the Revenue Commissioners and the Department of Finance are to be applauded for bringing in the measure sooner than anticipated. Refinement will however be required. But certain other measures will also be necessary if we are to provide a solid tax platform for building Ireland's Smart Economy. Specifically, we will need to improve our system for granting tax relief for taxes suffered on inbound royalty payments. We should also abolish the income tax charge on outbound patent royalty payments. We have made a very important step by introducing the Intangible Assets provision. Now let's make sure it works and gives companies the ability to thrive rather than just survive.

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