Invited Editorial

Tax treatment of subsidiary profits for Irish registered companies

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For several years, Ireland's headline rate of Corporation Tax of 12.5 per cent has been a significant contributing factor in attracting inward investment into Ireland. The growth in financial services, pharmaceuticals and technology companies has blossomed under this benign tax regime. However, of late, it is Ireland's treatment of profits made by foreign subsidiaries of Irish resident companies that has been attracting attention and encouraging, in particular, UK firms to cross the Irish Sea and become resident in Ireland in order to reduce their tax burden.

The existing British corporate tax regime is based on the principal of worldwide taxation. Dating from the late 1700s, multi-national companies that are domiciled in the United Kingdom must pay an additional charge on the gross value of any foreign earnings that they have channelled back to the United Kingdom. The additional charge is calculated on the differential between the UK rate (currently 28 per cent) and the applicable rate in the country that the subsidiary is operating in. This can result in a scenario where a UK company creates the vast majority of its profits overseas yet such profits are exposed to British tax even though the UK element of the company's business is quite small in comparison to its overall operations.

In tandem with taxing profits channelled back into the United Kingdom from overseas subsidiaries, the current controlled foreign corporation 'CFC' regime allows the UK

Treasury to deem that profits retained by overseas subsidiaries are held there for the purpose of tax avoidance and then to apply tax to any such retained profits. In practice, the amount of tax paid by British firms under the CFC regime is relatively small; however, it does create a substantial regulatory compliance burden as UK firms with overseas subsidiaries have to manage the interaction between the UK tax system and the systems in the various countries it operates subsidiaries from in order to minimise their CFC exposure.

It is, in large part, this treatment of foreign profits by the UK Treasury and the compliance burden that has led UK firms, such as United Business Media and Shire to set up Irish holding companies and become resident in Ireland for tax purposes.

Irish companies are liable for tax on any dividend a company receives from a foreign subsidiary. Dividends and other profit distributions received by an Irish resident company from an overseas subsidiary resident in the EU or a country with which Ireland has a double-taxation treaty¹ are liable for tax at 12.5 per cent on profits derived from trading (operating) activity.

Dividends from companies either in the EU or treaty countries, where the Irish resident has a holding of 5 per cent or less, are taxed at 12.5 per cent regardless of the type of activity. In addition, dividends resulting from mining, petroleum and certain property activities are taxed at 25 per cent.

Ireland does not operate a CFC type regime, and accordingly no income is imputed to an Irish parent, even if this income arises (and remains) in a subsidiary in a tax haven or in respect of passive activities.

In conjunction with the relatively low Irish tax rates outlined above, a credit is available for withholding tax and underlying tax imposed on the foreign subsidiary, which can have the effect of reducing the Irish tax rate to nil. The system works in practice by allowance for the fact that usually any such dividend has suffered withholding tax in its country of origin, and in addition, as is the normal practice, the dividend will have been drawn down from profits that were subject to corporation tax. The Irish tax system recognises both these forms of tax, and grants the Irish holding company credit for the foreign withholding tax and corporation tax.

Irish companies are allowed to avail of a system of 'onshore pooling', excess credits derived from trading activity can be offset against the tax liability on other dividends in the 12.5 per cent bracket. Excess credits derived from passive activity can be offset against tax on dividends taxable at either 12.5 per cent or 25 per cent. Unused excess credits in each year may be carried forward indefinitely.

In addition, Irish resident companies enjoy a participation exemption from Capital Gains Tax that ensures that any Irish resident company will not have a liability to account for Capital Gains Tax made on the disposal of subsidiary companies.

A UK company considering relocating its parent holding company to Ireland would need to consider how its particular operations fit into the Irish tax regime. A company whose subsidiaries are located in the EU or Irish double-taxation treaty countries would enjoy the maximum benefit; however, Ireland's system

of tax credits and onshore pooling means that a company principally acting outside these areas can take advantage of the Irish system. A UK company relocating to Ireland could avail of shareholder relief on disposals.

The incorporation of an Irish holding company is relatively straightforward and any company becoming Irish resident would not have to relocate its centre of operations to Ireland. There are some requirements that would need to be satisfied to ensure that such a company's residency in Ireland could not be challenged. The failure of the UK Inland Revenue's challenge to Cadbury Schweppes' decision to set up a treasury operation in Dublin's International Financial Services Centre demonstrates the solidity of using Ireland as a location for corporate and tax restructuring.

UK companies that are resident in Ireland may retain their listing on the London stock exchange, as recent changes to the stock exchanges rules means that a company does not have to be resident in the United Kingdom to be listed.

Ireland's membership of the euro, ease of access, legal system based on common law, an uncomplicated regulatory system and being an English-speaking country enables the adoption of Irish corporate residency to be relatively trouble-free, particularly for UK firms.

Brian O'Donnell & Partners
62 Merrion Square, Dublin 2, Ireland
E-mail: mglynn@brianodonnell.com

NOTE

- ¹ Ireland has an extensive list of double-taxation treaties with countries that produce over 90 per cent of world GDP.