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EU Tax Reform and its Impact on Ireland

In this article Peter Reilly examines EU tax policies and what they mean for Ireland

How did we end up here?

In the not too distant past, international tax reform moved at a glacial pace, inching forward but all the while melting around the edges to ensure that consensus was reached. However in recent years the international landscape has shifted and that glacier is rapidly becoming a river of change.
During the global economic downturn austerity inevitably led to the question of "fair share" and importantly who wasn't paying theirs. The tax bills of multinational companies came quickly into focus. This chain of events led to the establishment of the BEPS project at the OECD in 2013. This ambitious plan sought to snuff out aggressive tax planning by multinationals through a 15 point action plan. Two years (and much skepticism) later, the OECD did indeed come good on their promise of delivering final reports and while, in some instances, they fell short of their lofty goals, they far exceeded general expectations and the blueprint for reform was drawn.

With discussion and compromise happening in Paris (at the OECD's HQ), down the road in Brussels the EU felt a little left behind. Indeed were they not the ones who could, for their members at any rate, enforce laws rather than just agree on non-binding reports? Hence in an effort to wrestle back control the EU has acted swiftly.

The Anti Tax Avoidance directive – blink and you would have missed it

In an effort to wrestle back supremacy from Paris, the EU commission brought forward a directive designed to implement a number of BEPS initiatives across EU member states. Incredibly this directive, the Anti-Tax Avoidance Directive ("ATAD"), was debated, amended and agreed upon in under 6 months. To put this in context, if we substitute years for months in the previous sentence we would be more in the vicinity of the norm for EU tax directives. The ATAD incorporates five rules (three borne out of the BEPS project) which cover interest deductibility, controlled foreign companies ("CFC"s), hybrid mismatches, exit taxation and a general anti abuse rule.

The date of implementation varies from 2019 for some elements to potentially 2024 for interest deductibility (more on these below). But irrespective of the date that the directive must be transposed there is no doubt that the speed at which consensus was achieved has emboldened the EU for future ventures.

Other EU moves

In autumn 2016 the EU relaunched the Common Consolidated Corporate Tax Base CCCTB, a directive designed to agree a common base for taxation in the Union in the first instance followed by a consolidated tax return for the Union (or formula apportionment methodology of determining where a company should pay tax). CCCTB is the Holy Grail which policy makers in Brussels believe would right the wrongs of the world of taxation. In this author's opinion that Holy Grail would be more akin to a poisoned chalice (and not just from an Irish perspective). However sleepless nights are not the order of the day as it appears that reality is dawning on even the most ardent supporters that gaining agreement on this could be very difficult if not impossible. Hence while this is one that the EU might crave and even with the ATAD wind at their backs, CCTB/CCCTB is unlikely to succeed (in its current form at any rate).

The EU will however remain emboldened in their mission to bring about reform and to stamp out perceived avoidance schemes by multinationals. New items on the agenda include a directive on mandatory disclosure rules, requiring "promoters" (read tax advisors) to disclose certain structures, further work on the EU's "blacklist" and of course ongoing state aid investigations by the competition arm of the Commission.

What does all of this mean for Ireland?

The agreement in mid-June of 2016 of the ATAD will mean that a number of changes are on the way for Ireland's tax code. The direct results of this directive are that Ireland will need to amend our exit tax legislation to ensure that all companies are taxed on exit, introduce anti-hybrid rules to curb abusive transactions involving hybrid mismatch arrangements, introduce CFC rules and amend our interest deductibility rules. It is the latter two items which are most likely to have the biggest impact on Irish companies and as such a brief summary of these are provided below.

Controlled Foreign Company Legislation

By 1 January 2019 Ireland will have to introduce CFC for the first time. The introduction of these rules, which in general terms seek to tax "passive" income of low tax foreign subsidiaries on a current year basis (rather than when remitted as is currently the case), will be a significant change for groups operating in Ireland.

The impact will depend on a number of factors including the type of entity involved, the income earned, the distributions made and the effective rate of tax. However if we break it down simply, CFC legislation could result in Irish tax being applied to low/no-tax profits of subsidiaries such as low tax financing vehicles. Options chosen by Ireland on certain carve-outs contained in the directive will be key to understanding the impact at an individual company level.

There may be one silver lining which could soften the blow of CFC legislation and that would be the potential introduction of some form of participation exemption for dividends and branches. Ireland is one of the very few countries that does not operate such a "territorial" system. In the past, the policy argument provided for a lack of such an exemption regime was that the introduction of same would necessitate CFC legislation, hence would the (now mandatory) introduction of CFC legislation not prompt the introduction of such an exemption?

Interest Deductibility

While we know that CFC legislation must be enacted by 31 December 2018, the deadline for the introduction of the interest deductibility rules is not as clear. Per the Directive the rules must also be implemented by 31 December 2018, however a derogation is offered for countries whose rules are equally effective at targeting BEPS. Such countries can delay implementation until final agreement is reached by the OECD on a minimum standard for Action 4 (interest deductibility) of the BEPS project or until 2024 at the latest. Given the complex nature and the various layers of anti-avoidance embedded in Ireland's rules relating to interest deductibility, I would expect that Ireland has a strong case in this regard and would expect Ireland to apply the derogation and delay implementation.

The interest rule seeks to cap "exceeding borrowing costs" to a maximum of 30% of EBITDA. The definition for excess borrowing costs is broad as it pits deductible borrowing costs of a taxpayer against taxable interest revenues and other economically equivalent taxable revenues. Essentially though the directive is trying to cap net borrowing costs (e.g. interest) to 30% of EBITDA with a number of exclusions and carve outs on offer for member states to implement as they see fit (e.g. a de-minimis rules, a group wide carve-out etc).

A Time of Change

When the ATAD is taken together with the wider changes proposed by the OECD through the BEPS project and any recommendations coming out of the Coffey Report on Ireland's tax code (which will likely be released by date of publication of this article), it appears that the officials on Merrion Street have a busy few years ahead. What will become increasingly important for Ireland though is the absolute need to remain competitive and consistent in our approach to corporate tax policy. The Department of Finance's mantra that our tax code is built upon rate, regime and reputation has sound foundations given our steadfast commitment to the 12.5% rate in the darkest days of the recession, however we cannot rest on our laurels as international investment decisions (by both Irish and foreign groups) can be swayed by subjective factors such as perceived stability and the assurance that significant change won't be brought in without consultation and transitionary measures.

The decision and subsequent reinforcement by successive Irish Governments, for more than 50 years, to prioritise and incentivise substance based investment and the later resolution to centre our tax regime on a low rate/broad base approach gives Ireland a significant leg-up on some of our competitors. However in a time where scrutiny on regimes is increasing and where international efforts (either at an EU or OECD level) are often swayed by larger countries' vested interests, Ireland must ensure that our competitiveness is not mistaken for aggressiveness. It is also crucial that Ireland signals its intentions to stakeholders in relation to the course of action it will take on directives, such as the ATAD, to ensure that stability and consistency is maintained. Finally, Ireland must continue to push back where necessary, as they have done in relation to the Apple state aid case, where they believe the EU are overstepping their mark.