EXECUTIVE BOARD MEETING

SM/18/153
Correction 1

June 19, 2018

To: Members of the Executive Board

From: The Secretary

Subject: **Ireland—Selected Issues**

Board Action:	The attached corrections to SM/18/153 (6/12/18) have been provided by the staff:
Mischaracterizations of the Views of the Authorities	**Page 33**
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 36 and 42 (para. 2, line 8)**
Typographical Errors	**Pages 42 (para. 2, line 2) and 43**
Questions:	Mr. De Vrijer, EUR (ext. 38328) Mr. Giustiniani, EUR (ext. 37012) Mr. Klein, EUR (ext. 36706) Mr. Podpiera, EUR (ext. 36753)

the rules of the existing tax system, retaining its basic features of separate accounting and arm's length pricing.

32. The BEPS project consists of 15 "actions", which are divided into minimum standards, and best practices. The EU, including Ireland, is in the vanguard of countries moving ahead with implementation of those actions. Actions 2, 3, and 4 are embodied in the ATAD, discussed in the following section. The Coffey Report (Coffey, 2017) made extensive recommendations for transposing to national law Ireland's commitment to the BEPS project, including detailed recommendations on transparency (Chapter 5), transfer pricing (Chapter 6) and anti-abuse issues including hybrid mismatch arrangements and controlled foreign corporation (CFC) provisions (Chapter 7). As recommended by the Coffey Report, the Irish authorities are considering adopting the updated 2017 OECD transfer pricing guidelines and broadening the application of transfer pricing ~~in the next revenue bill~~.[23] Ireland has also implemented the four BEPs "minimum standards"—exchange of information (Action 5), anti-treaty shopping (Action 6), country-by-country reporting and transfer pricing documentation (Action 13) and mutual agreement procedures (Action 14)—and passed or scheduled peer reviews for all four.

33. The concept of "substance" as the determinant of the location of income is central to the BEPS agenda, particularly as expressed in the transfer pricing guidelines. In practice, this means inquiring whether observable commercial undertakings, in headcount, managerial responsibilities, tangible investments, and commercial risk assumption and management (but not pure financial risks divorced from other functions), and similar factors align with the jurisdiction in which income is recorded for tax purposes. In connection with IP, these functions are summarized in the OECD BEPS work as the development, enhancement, maintenance, protection, and exploitation of that IP — the "DEMPE" functions. Work is progressing on the open transfer pricing issues that remain, namely the taxation of hard to value intangibles. It is anticipated that by 2020 any open transfer pricing issues will have been resolved.

34. Ireland signed the Multilateral Instrument (MLI, BEPS Action 15) in 2017, and expects to fully ratify and implement it within the next two years. The effect of this process will be to align its numerous bilateral tax treaties more closely with BEPS standards regarding all treaty partners who are also signatories to the MLI. (This excludes the U.S., which has not signed the MLI.) Ireland has reserved on Article 10 (denying treaty benefits to low-tax permanent establishments (PEs) in third countries); Ireland does not exempt PE or branch income. Article 11 (the "saving clause" preserving a country's right to tax its own residents under domestic law) and Article 12 (extended definition of PE to cover certain agency relationships, such as commissionaire arrangements). On treaty shopping, Ireland is expected to adopt the "principal purpose test", which disallows treaty benefits if the principal purpose of an arrangement is to obtain that benefit, unless allowing it is consistent with the purpose of the treaty.

[23] See OECD (2017). Ireland's existing transfer pricing rules (as of August 2017) are summarized in an OECD questionnaire available at http://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-ireland.pdf .

between member states. The first denied one deduction where a hybrid otherwise would lead to a double deduction, and the second denied a deduction where the income was not included on the other side of the transaction. ATAD II completely revised those provisions with more complex and far-reaching measures that apply to transactions involving at least one EU member state as well as to "reverse hybrids"—where an entity is treated as a fiscal transparency in the source state but as a separate company in the residence of the owner. The revised provisions must be transposed into domestic law by the end of 2019, although the reverse hybrid rule can be deferred until the end of 2021.

45. Hybrid and reverse hybrid arrangements are creatures of aggressive tax planning, not genuine business transactions. Their widespread propagation and rapid evolution have depleted tax revenues around the world.[24] The new ATAD rules, together with the robust exercise by the U.S. Treasury of the very broad authority derogated to it by the Congress in the TCJA in respect of hybrid transactions, could be expected to very substantially reduce the impact of these sorts of schemes on a global basis.

46. The ATAD anti-hybrid rules are not expected to have a material impact on domestic operations in Ireland, where hybrid arrangements are reportedly uncommon. Nonetheless, hybrids feature heavily in U.S. tax structures involving Irish operations, particularly as a result of those structures' reliance on "check the box" planning.

Exit Tax

47. Article 5 of ATAD 1 requires member states to adopt an "exit tax" that would apply to transfers of assets in or out of the Irish tax base. The exit tax must take effect by January 1, 2020. The ATAD it leaves to each member state to set the exit tax rate; the tax base is the fair market value of the transferred assets less their tax cost. Ireland has an exit tax in place, but it is not as broad as required by ATAD, so Ireland will need to amend it.

48. Ireland should consider carefully the design of its exit tax in order to protect its CIT revenues over the long term. The design of this exit tax will be ~~extremely~~ important to long-term levels of Irish CIT revenues: As described in the Annex, MNEs have in some instances "on-shored" IP formerly held offshore of Ireland (in, for example, Double Irish structures). For IP on-shored in 2015–17, Irish CIT as then in effect allowed capital allowances and interest expense on debt incurred to purchase such IP to offset 100 percent of the revenues generated by that IP. (The sum of these expenses is limited to 80 percent of IP revenue for IP on-shored from 2018 onwards.) When that capital allowance is exhausted in several years' time, firms will face Irish CIT at the 12.5 percent rate on large amounts of unsheltered income. Robust exit taxes will preserve

[24] One well-known example of a hybrid is the "Tower Structure" employed by many U.K. enterprises to fund investments in the United States. In return for a modest investment in tax advice and the formation of two companies, firms obtained a double deduction of the cost of financing their U.S. investment. See Dodwell (2014).

Annex I. Tax-Minimizing Structures

MNEs with an Irish presence have used a variety of structures that play off discrepancies in international tax rules to reduce their corporate tax liabilities. Prominent examples include:

1. Double-Irish Dutch Sandwich. Prior to 2015, the Irish definition of tax residence depended on the place of a company's effective management rather than incorporation. An MNE could therefore establish two subsidiaries in Ireland: an operating company that was both incorporated and tax-resident in Ireland, and an IP holding company that was incorporated in Ireland but tax-resident in a jurisdiction with extremely low or no corporate income tax. The operating company would receive income from sales throughout the region, but offset almost all of it with royalty payments to a related subsidiary in the Netherlands, which attracted no withholding tax.[1] The Dutch company in turn distributed these payments to the "Irish" IP holding company as royalties. Dutch income tax was levied only on a small spread in the royalty rates, and there was no Dutch withholding tax on the payment of royalties under Dutch domestic law. From a U.S. perspective, however, the income still appeared to be in Ireland, because the three entities would be combined into one Irish corporation through "check the box" elections. The 2015 change in Ireland's definition of tax residence to encompass all entities that are either incorporated or effectively managed in Ireland precluded these structures; however, existing structures were grandfathered through the end of 2020.

2. Single Malt. In this structure, royalties from the Irish operating company are paid to an Irish-incorporated but Maltese tax resident company managed and controlled in~~,~~ Malta. Since Malta is also an EU member, there is again no withholding tax on that payment, and although Malta has a high CIT rate of 35 percent, it does not tax income earned entirely outside of Malta. Because the company is deemed Maltese-resident for the purposes of the Ireland-Malta tax treaty, it is also treated as Maltese-resident for Irish domestic law purposes, notwithstanding that it is Irish incorporated. Thus, although Ireland's domestic law no longer permits ~~establishment of dual-resident corporations~~ incorporation without tax residency, ~~they~~ such a structure can still be established under one of its tax treaties.

3. IP on-shoring. Given the waning viability of IP conduit structures, IP-rich MNEs have explored "on-shoring" strategies that also exploit asymmetrical treatment of the transaction by Irish and U.S. authorities. Irish law permits an Irish resident company to amortize the purchase price of IP over 15 years or at the rate used in the firm's financial accounts. In an on-shoring transaction, the Irish company purchases highly valued existing IP from the offshore company using accumulated cash and/or debt. The Irish company can then claim

[1] The EU Interest and Royalty Directive eliminates the application of intra-EU withholding taxes on cross border interest and royalty payments in many cases regardless of whether the intra-EU tax treaties allow for withholding taxes on cross-border interest and royalty payments. Similarly, the EU Parent-Subsidiary Directive eliminates withholding taxes on participating dividend payments between EU member states.

capital allowances based on the full purchase price as well as any related interest expense against the income it derives from licensing the IP or associated product sales. From a U.S. point of view, however, the purchase is a transaction within a single corporation and thus generates no tax consequences. On-shored IP income is ring-fenced so that losses cannot offset other trading income. Up to 2015, IP capital allowances and interest on acquisition debt were limited to 80 percent of IP income, but as of 2015 this limit was abolished. In accordance with a recommendation of Coffey (2017), the 80 percent restriction was re-introduced in 2018; however, IP on-shored in the 2015–17 period is grandfathered with respect to this rule. This onshoring strategy contributed to the 25.5 percent surge in Irish real GDP in 2015.