A TAXING QUESTION

Expanding into international markets will be a key part of many firm's plans to grow their business. Marie Bradley, managing partner of Bradley Tax Consulting, highlights some of the tax implications.

The property boom is over; global recession is a reality; and the significant liquidity problems in the Irish banking sector will continue for a while. Many Irish businesses find themselves in uncharted waters. Those previously involved in the Irish property boom are experiencing significantly reduced volumes of work in Ireland and are forced to go abroad to tender for construction and infrastructural projects in emerging markets, e.g. the Middle East and Africa.

Commentators are indicating that export-led growth is the only sustainable strategy to secure long-term growth and prosperity in Ireland. However, for those companies already exporting goods and services, the dynamics of the world market are changing – the traditional export locations' (EU, US and Japan) share of world GDP has fallen from two-thirds in 2000 to 48 per cent today and is expected to reach one-third by 2016; it is expected China, India and other countries in the East will account for a higher proportion of world GDP in future years. However, the problem for Irish exporters is that only 10 per cent of Ireland's exports go to emerging markets and developing economies so a major change in focus is required.

Therefore, many Irish companies are looking to do business abroad for the first time while others are seeking to export to new markets that they have no experience in. The National Competitiveness Council recently published its report, *Driving Export Growth: Statement on Sectoral Competitiveness.* Therein. tax is identified as a critical factor driving competitiveness in six out of the eight sectors analysed. While the reference to tax in this report may refer to the Irish tax landscape, any company expanding abroad or exploring new markets will have to address some or all of the following Irish domestic and international issues:

– Operating structure
– Repatriation of profits
– Financing of foreign operation
– Exit mechanisms
– Indirect tax considerations
– Employee secondments
– Miscellaneous taxes
– Assistance from Governmental agencies

This article addresses each of the above areas and highlights some of the relevant factors to be considered.

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OPERATING STRUCTURE

The three structures used by companies when expanding overseas are a representative office, branch or subsidiary.

Representative office

A representative office is the easiest way for a company to commence activities in a foreign location and does not require the incorporation of a separate legal entity. Such offices are generally used to carry out preparatory activities, e.g. marketing, and give rise to no taxable presence. There is generally a requirement to register for local payroll taxes in respect of any employees.

Branch

A branch structure, like a representative office, does not necessitate the incorporation of a separate legal entity. The branch will, however, because of the increased level of activities, create a taxable presence for the Irish company in the foreign location. It is, therefore necessary, to register and account for local corporate tax on the branch's profits.

Subsidiary

This generally involves the incorporation of a separate legal entity that will be tax resident in the foreign jurisdiction. The Irish parent will only be subject to Irish tax on profits to the extent that they are repatriated via dividends. Establishing a subsidiary may be a commercial necessity in many instances so the establishment of a branch or representative office may not be relevant.

REPATRIATIONS

Branch operations

Where an Irish company decides to proceed with a branch structure and profits arise in same, these profits are taxable in Ireland and the territory in which the branch is located. The Irish company can, however, claim a credit in respect of foreign corporation tax paid on profits of the branch and excess foreign tax credits from one branch may be offset against Irish tax on another branch or carried forward to future periods.

Subsidiary companies

Irish companies repatriating dividends from foreign subsidiaries must consider how these dividends will be taxed in Ireland. Dividends received by an Irish resident company from a foreign subsidiary are liable to tax at 25 per cent or 12.5 per cent. It is possible to get a credit for withholding tax deducted at the time of payment of the dividend and for underlying tax paid by the subsidiary. Should excess foreign tax credits arise, excess credits from one dividend source may be offset against the Irish tax arising on other foreign dividends and unused credits can be carried forward to future periods indefinitely.

Transfer pricing

Transfer pricing rules seek to enforce arm's length pricing on transactions between related parties. Ireland recently introduced transfer pricing provisions for groups that employ more than 250 employees and either have a turnover of more than €50m or assets of more than €43m. These figures apply to the worldwide group and are reviewed annually.

Even if an Irish group is outside the scope of the Irish transfer pricing provisions, Irish companies operating in foreign jurisdictions will need to be conscious of foreign transfer pricing regimes when structuring their international operations.

FINANCING OF FOREIGN OPERATION

Setting up international operations abroad will require an efficient financing structure to be put in place which seeks to achieve some or all of the following:

- Tax deduction in Ireland where the Irish parent funds the expansion with increased borrowings
- Tax deduction for interest paid by the foreign subsidiary on loans provided to fund operations
- With regard to the second point above, foreign country thin capitalisation provisions that seek to restrict interest deductibility should be considered, particularly if the intention is to maximise the level of debt in the foreign subsidiary so as to minimise the charge to corporation tax.

There is an exemption from capital gains tax on gains realised on the disposal of certain shares held by an Irish holding company.

EXIT STRATEGIES

When developing a tax structure for a group with international operations, it is important that some tax-free exit mechanisms are in place in the event of a disposal of elements of the international group.

There is an exemption from capital gains tax on gains realised on the disposal of certain shares held by an Irish holding company. The Irish parent must hold (directly or indirectly) at least a 5 per cent shareholding (including the right to 5 per cent of the profits and assets on a winding up) of the subsidiary company for a twelve month period. At the time of disposal, the subsidiary must be a trading company or, alternatively, the test may be satisfied on a group basis where the business of certain members of the group consist wholly or mainly of the carrying on of a trade or trades. Finally, the subsidiary must be resident in the EU (including Ireland) or a DTA jurisdiction. If the subsidiary is resident in a non-treaty territory, then alternative holding structures can be implemented.

Indirect tax considerations
Initially, a foreign operation may be loss making, so a corporation tax liability may not arise immediately. However, VAT and customs duty issues may result in cash tax liabilities from the outset, so their importance cannot be ignored.

TRANSFER OF EMPLOYEES

In any foreign start-up, the Irish head office is likely to transfer highly-skilled employees abroad to supervise and control the investment in the target location and manage local employees. The residence position of the individual and the charge to taxation on employment income is dependent on the duration of the international assignment, i.e. temporary or long term. It is important that the implications of continuing to be paid by the Irish employer or transferring to the payroll of the foreign entity are understood. The tax implications of providing accommodation in the new location and paying sums in respect of travel and subsistence must also be addressed.

MISCELLANEOUS TAXES

Taxes on capital
Some foreign jurisdictions impose net-worth taxes based upon business net worth at the end of the financial year. Also, many municipalities levy annual real estate taxes on commercial and private property for which a corporation tax deduction may be available. These taxes can add to the overall effective tax rate payable in any jurisdiction.

Capital duty and stamp duty
Unlike Ireland, many countries impose taxes on contributions of capital, whether in cash or kind. Transfer of shares, bonds and other securities as well as immovable property, may give rise to stamp duty or other transfer taxes. However, in most cases, the rates of tax are much lower than similar taxes imposed in Ireland.

LOCAL PRACTICES

Many undeveloped countries operate local practices that may not be transparent to foreign companies at the outset. Working in co-operation with local distributors or joint venture partners may be a way of ensuring full compliance with local laws. In practice, a higher standard of compliance with all relevant laws and regulations may be expected of foreign companies than applies to domestic businesses and this poses challenges for Irish companies commencing foreign operations.

Companies that wish to expand their business into international markets should tread carefully and seek appropriate tax advice in advance of setting up their business operations. The criteria outlined above should provide some guidance in developing a tax structure but it is necessary to understand the foreign tax issues and their interaction with the Irish system in the context of the specific fact pattern relevant to each client. It is also important that groups continually monitor the tax regime of the countries they operate within, after they set up their tax structure, as annual legislative amendments may require groups to make changes in due course.