Going international with your business:

Tax considerations to be addressed

by Marie Bradley

Introduction

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 unchartered 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 eg 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% 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% 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;

1. Operating structure
2. Repatriation of profits
3. Financing of foreign operation
4. Exit mechanisms
5. Anti-avoidance legislation
6. Indirect tax considerations
7. Employee secondments
8. Miscellaneous taxes
9. Assistance from Governmental agencies

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

1. Operating structure

The structures used by companies when expanding overseas are

1) Representative Office
2) Branch
3) 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 eg 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, due to 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. A branch structure is sometimes used if it is anticipated that the branch will incur losses initially as the branch's trading losses can be offset against the Irish head office's trading profits thus giving cross border loss relief.

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.

2. 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, even if it is located in a non treaty country. Where the foreign tax rate is higher than 12.5%, it is unlikely that any incremental tax would be due on branch profits taxable in Ireland. In addition, where foreign tax paid on branch profits exceeds the Irish tax payable on such profits in any particular year, the excess credit can now be pooled and credited against Irish tax on branch profits in other countries where the foreign tax is not sufficient to cover the Irish tax. However, there are no provisions enabling any excess credits to be carried forward. Where a branch structure is used, no additional issues arise in respect of profit repatriation as transactions between the branch and head office are ignored.

Subsidiary companies

Irish companies repatriating dividends from foreign subsidiaries must consider how these dividends will be taxed in Ireland. Ireland operates a foreign tax credit system as opposed to a system of participation exemption ie an exemption from tax for dividends received from certain subsidiaries. Dividends received by an Irish resident company from a foreign subsidiary are liable to tax at 25% or 12.5% if the dividend is paid out of trading profits of a subsidiary resident in an EU or Double Taxation Treaty (“DTA”) country provided an election is made to tax this income at 12.5%. 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.

Credit for foreign taxes may be available under

- Irelands double tax treaties
- Unilateral credit relief provisions
- EU Parent Subsidiary Directive and
- On shore pooling provisions

In general terms if the foreign tax rate exceeds the Irish tax rate, full credit should be available for the foreign taxes suffered. Should excess foreign tax credits arise, the onshore pooling provisions allow excess credits to be offset against the Irish tax arising on other foreign dividends where the foreign tax on those dividends is less that the Irish tax on the same dividend. Unused credits can be carried forward to future periods indefinitely. With appropriate planning, it may be possible to ensure that no additional tax arises on foreign dividends.

It may not in every instance be appropriate to elect to pay tax at 12.5% on dividends from EU/Treaty countries where dividends are also received from non DTA countries. The reason for this is that excess credits arising on dividends taxable at 12.5% are not available for offset against dividends taxable at 25%. Companies should consider the mix of foreign dividends that they expect to receive before making an election to pay tax on a foreign dividend at 12.5%.

In many instances, foreign tax credit relief arises only in respect of underlying profits of the subsidiary as DTA provisions reduce withholding taxes on payment of dividends to Ireland to nil. Profit repatriations from non double taxation treaty locations may be more complex if foreign withholding taxes are imposed and the underlying tax paid exceeds the tax due in Ireland once it is repatriated. These issues can be mitigated through appropriate planning.

Controlled foreign company (CFC) rules

Controlled foreign company (CFC) rules refer to the timing of taxing profits of companies with business operations in foreign jurisdictions in the territory of the parent company. Generally, the profits of a subsidiary are only taxed on repatriation by way of dividend.

CFC rules impose exceptions to this rule and the profits of a CFC may be attributed to the parent when the profits arise in the subsidiary, with a credit for tax paid by the subsidiary. CFC provisions seek to prevent companies in high tax locations from avoiding domestic tax by setting up operations in low tax locations, thus moving income of the parent company offshore.

While it is widely understood that Ireland does not have CFC legislation there is a CFC type provision in S590 TCA 1997 which applies to close companies. This provision taxes an Irish resident on their portion of a gain arising in a non resident close company in certain circumstances and thus enables Revenue to look through the non-resident controlled company to its Irish individual shareholder and assess them to Irish capital gains tax on their share of the gain in the company. There are exceptions for certain gains eg gains that arise on the disposal of tangible property used for the purposes of a trade. Close companies investing abroad should be aware of these provisions. In some cases, DTA relief may be available to eliminate the Irish charge to capital gains tax. Further, this provision could be in breach of the EU freedom of establishment and free movement of capital if the foreign company were resident in an EU Member State.

The S590 provisions were originally introduced to prevent Irish resident individuals avoiding Irish capital gains tax by transferring assets to controlled companies abroad. There have been many calls for S590 to be abolished but it still remains in the Irish statute books.

Inbound interest and royalty payments

If foreign subsidiaries pay interest or royalties to companies in the Irish group, withholding tax considerations may arise. As regards interest and royalties from EU member states, double taxation treaties provide relief for withholding taxes as do the provisions of the Interest & Royalties directive. Where Ireland’s tax treaties already give more extensive benefits they will supersede the Interest & Royalties directive.

Where interest receivable is taxable as Case I trading income, arises from a source within a DTA country and is received from a 25% group company, then interest excess credits may be pooled and offset against Irish tax on other interest income received in the same financial year. However, excess credits may not be carried forward to future periods.

Transfer pricing

In general terms, Ireland does not have a comprehensive transfer pricing regime. However, transfer pricing rules in a foreign jurisdiction may enforce arm's length pricing on transactions between related parties. Therefore, Irish companies operating in foreign jurisdictions will need to be conscious of foreign transfer pricing regimes when structuring their international operations.

Transfer pricing issues will arise to the extent that financing and/or intellectual property structures or management fee arrangements are used as mechanisms to transfer profit from the foreign subsidiary to Ireland. These arrangements may be complicated by withholding taxes imposed by tax regimes based in developing countries.

3. 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:

1. Tax deduction in Ireland where the Irish parent funds the expansion with increased borrowings
2. Tax deduction for interest paid by the foreign subsidiary on loans provided to fund operations.
3. A double dip for interest paid.

With regard to (2) above, foreign country thin capitalisation provisions and other restrictions on 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.

Thin capitalization rules provide that interest paid by a subsidiary in one country to an affiliate in another country can be deemed a non-deductible distribution of profits where the debt equity ratio of the interest paying company exceeds a certain threshold. Therefore, a foreign tax jurisdiction may seek to disallow all or some of the interest paid on loans to finance a foreign subsidiary.

Under Irish law there exists a limited form of thin capitalisation as set out in s130(2)(d)(iv) TCA 1997. This provision seeks to re-categorise interest as a distribution in certain circumstances.

When setting up a financing structure for a foreign entity the local debt equity ratios will need to be understood so that interest deductibility can be maximised if this is desired. As part of any exercise, it is important that the financing structure is well thought through and withholding taxes on interest are also minimised where possible.

4. Exit strategies

Capital gains tax exemption on sale of shares in subsidiaries

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.

S 626B TCA 1997 provides for 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% shareholding (including the right to 5% 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 the 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.

Intermediate holding companies

Where S626B relief is not available because the subsidiary company is located in a non DTA country, consideration should be given to having an intermediate holding company between the Irish parent and the foreign subsidiary. This may also be necessary to the extent that significant withholding taxes are suffered on the payment of dividends, interest and royalties by the foreign subsidiary to the Ireland parent company, particularly if no DTA exists between Ireland and the country of residence of the foreign trading company.

Where possible the objective is to have nil or minimal withholding taxes on payments of interest, dividends and royalties from the subsidiary to the intermediate holding company and from there to the Irish parent company. The tax regime within which the intermediate holding company falls should have participation exemption in respect of dividend income and minimal taxes on interest and royalties. Finally, no capital gains tax should arise on the disposal of shares in subsidiary companies owned by intermediate holding company. To the extent that the country of tax residence of the intermediate holding company does not have thin capitalisation or CFC rules, that is also helpful.

5. Irish anti-avoidance legislation - *Transfer of assets abroad*

S806 TCA 1997 is an anti-avoidance provision which seeks to prevent Irish tax resident or ordinarily resident individuals from avoiding Irish income tax on transferring assets abroad where as a result of the transfer income becomes payable to a person who is resident or domiciled outside of the State (e.g. foreign company). This enables Revenue to deem the income to be that of the individual that has made the transfer, i.e. where the transferor has the power to enjoy the income. A genuine commercial transaction effected in the course of a trade or business, or with a view to setting up and commencing a trade or business should not fall within this anti-avoidance provision.

6. 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.

7. 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 ie 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. If an individual is assigned to a country with which Ireland has agreed a DTA and remains within the charge to Irish tax on his employment income, a credit for foreign tax is likely to be available. However, in the cases of relocation to non DTA countries, Revenue may only give a deduction for foreign taxes by concession, thus increasing the overall tax burden on remuneration. This raises many issues for employers, including whether or not they should put tax equalisation policies in place. The personal tax implications for individuals who travel between Ireland and foreign countries in which business operations are located must also be addressed.

8. 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.

9. Assistance from Governmental agencies: Enterprise Ireland

Enterprise Ireland is the government agency responsible for the development and promotion of the indigenous business sector. Their mission is to accelerate the development of world-class Irish companies to achieve strong positions in global markets resulting in increased national and regional prosperity.

Through its extensive network of Irish and international offices, Enterprise Ireland works with various clients to assist them to compete and to grow. Any company seeking to expand abroad should contact Enterprise Ireland and request their assistance. Its experienced business personnel have a wide network of in-market contacts and access to up to date market information. Many Irish companies openingly acknowledge that the doors that Enterprise Ireland opened for them through their contact base accounted for the initial success of their businesses in their new market.

Companies that wish to expand their business to international markets should thread 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.

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For further information contact: Marie Bradley, Managing Director, BT Consulting,
Address: 30 Pembroke Street Upper, Dublin 2.
Tel: + 353 1 400 4123 **Fax:** +353 1 234 2400 **Mobile:** + 353 86 2856880
E-mail: marie.bradley@btconsulting.ie

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