Ireland's Corporate Tax System

by Peter Reilly

In this article, Peter Reilly examines why corporation tax receipts are so high, and whether this is sustainable.

Ireland is stuck in a comical paradox at present and I must admit that if I was an official on Merrion street I'd be pulling my hair out when wading through the commentary proffered on our corporate tax system.

If you were to believe certain commentators, we are collecting too much and too little corporation tax all at the same time!

Ireland is accused of being a location in which Multinationals can operate without paying any tax and yet simultaneously Ireland is overly reliant on buoyant corporate tax receipts which are unsustainable - therein lies the paradox of current public perception.

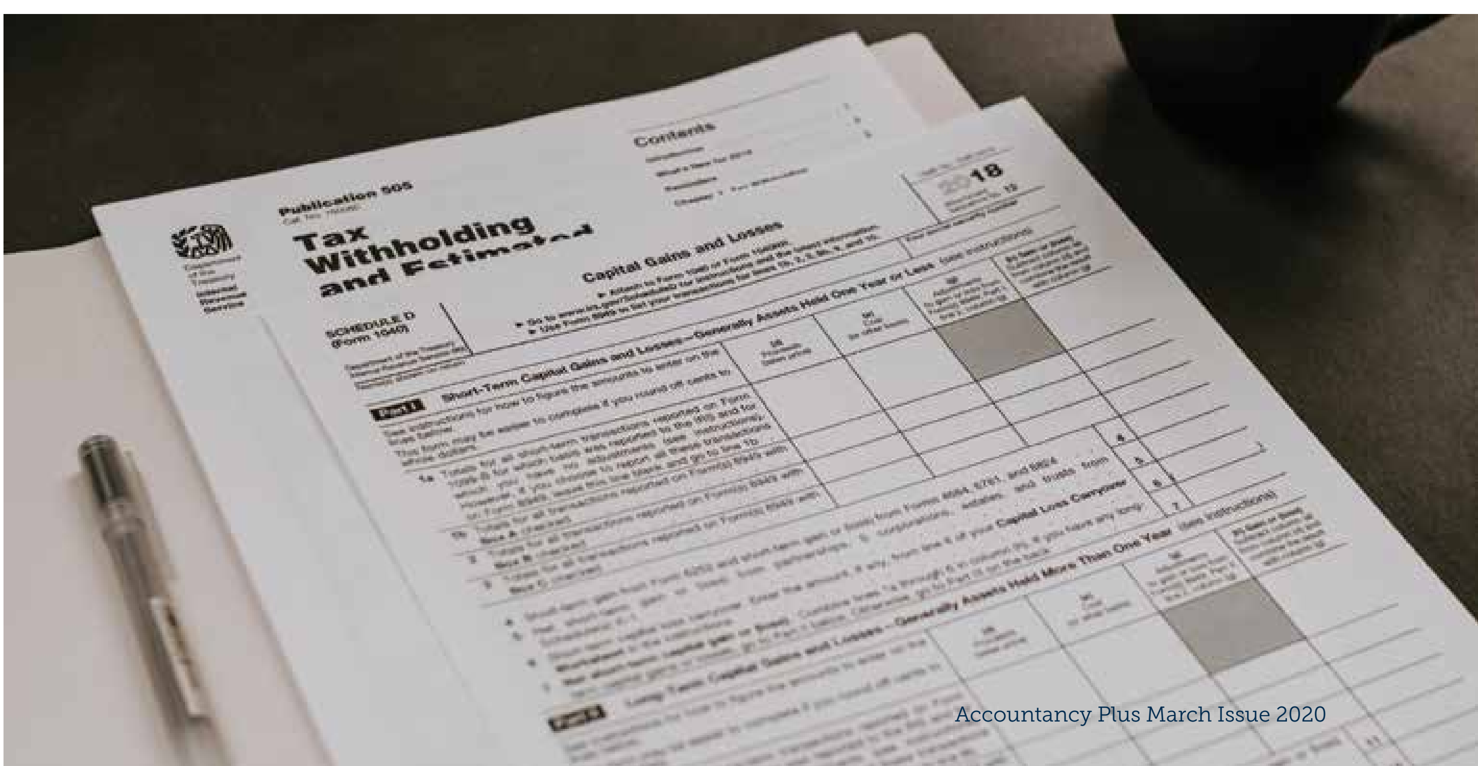
So why does Ireland get such bad press? To use a very Irish phrase, in my opinion, it's tall poppy syndrome. Ireland made an inspired decision many years ago to move from an incentives-based system to one which offered a low tax rate to all corporates, albeit on a wider base.

The intervening history tells us that this was a clever move and indeed has been copied to a greater or lesser extent by most developed countries across the world which has resulted in a significant decrease in average corporate tax rates across the OECD.

Right from the early years of this process, Ireland found that capital inflows would increase and that the "lost" revenue as a result of the rate drop was more than made up for by additional business being undertaken here. Crucially this system was also based upon substance and was not a "letter box" regime. Hence, if you were willing to invest in Ireland with substantive business functions and jobs then you were going to be able to achieve a low corporate tax rate on your Irish profits. Ireland has also been able to keep with the times and has tracked the global shift of jobs and labour, therefore the substance and functions in Ireland have risen up the value food chain as we have moved away from manufacturing towards Research and Development and Intellectual Property ("IP") exploitation. The success of Ireland's regime can be measured, from a Foreign Direct Investment perspective, by the fact that many non-Irish multinationals have their EMEA HQs based in Ireland.

This, however, hasn't gone unnoticed and it is has made us the envy of many of our European counterparts. Certain countries are uncomfortable with the idea that Ireland can attract this type of investment and that companies can book profits in Ireland for goods or services that are sold in their jurisdictions. This has been exacerbated by the digital age, but in reality, is this any different to catalog sales? – Albeit on a much larger scale.

Countries and commentators who are uncomfortable with Ireland's model cite past tax planning structures such as the double Irish (which will be officially closed for business from the end of this year) as the reason that Ireland attracts this investment.



They also argue that these structures mean that Ireland does not, in fact, tax profits of multinationals and that instead the profits lie untaxed in the sunny Caribbean islands. While there is no denying that the double Irish was indeed a structure that did allow multinational groups to place valuable IP in no- tax jurisdictions, this IP was never Ireland's to begin with and as such, why would Ireland have been entitled to tax these profits? Furthermore, the advantage that multinationals were able to take arose from a mismatch in rules between Ireland and the US and was not a specific provision designed by Ireland with this outcome in mind. Irrespective of this, Ireland came under pressure to change our laws to ensure that this structure was no longer able to be used and they did that in 2014 with a multi-year grandfathered period to allow groups the opportunity to transition.

If you believed that Ireland wasn't bringing any value to multinationals beyond this structure, then surely these changes would result in significant capital outflows from Ireland? Well that's not been the case. In reality, Ireland has seen a significant amount of that IP being brought "on-shore" with these groups choosing to "double down" on their Irish substance by further building on the significant functions which underpin this IP. Indeed the OECD's transfer pricing guidelines (which are followed by the majority of developed countries) ensure that the residual (or super) profits related to IP can only flow to jurisdictions that can demonstrate that they carry out all of the significant functions related to that IP – the so called DEMPE (Development, Enhancement, Maintenance, Protection and Exploitation) functions. In simple terms where Ireland doesn't carry out these functions, we can't keep the profits.

Hence, Ireland has seen a further increase in substance-based activity and has seen significant amounts of IP being brought here. This has resulted in increased profits (even though some of these profits can be sheltered by amortization of these assets) which has been one of the key drivers in Ireland's significant increase in corporate tax receipts.

So, in some respects Ireland has written the play book for using fair tax competition to attract investment. Ireland is following the OECD's rules emanating from the BEPS project. BEPS and closure of the double Irish has led to multinational groups seeking new homes for their IP and Ireland is getting a share.

So, what's the problem?

The first BEPS project was supposed to cure all the woes of international tax and while it was heralded for ensuring that profits had to follow substance, countries are now not so much looking at how much tax multinationals are paying, but rather where they are paying it. At the end of the day, as with every other international agreement, it comes down to politics and BEPS 2.0 is the embodiment of this political will. This project, again being run by the OECD, is focusing on giving more to market jurisdictions and trying to put a minimum tax concept on the international tax table. What will all of this mean for Ireland? That's the billion-euro question!

Ireland has outperformed corporate tax revenue targets consistently over the last number of years and the increases haven't been small. Can these be relied upon to last into the future or are they a temporary bonus? The answer will likely lie somewhere in the middle. As mentioned above, one of the fundamental pillars of BEPS 2.0 is to ensure that a larger portion of tax revenue is given to market countries. If this goes ahead, we could end up in a scenario where some of the tax revenues that Ireland currently enjoys are portioned out to market countries who buy the goods/services from the multinational groups based in Ireland. The devil will be in the detail here, but this represents a significant risk for Irish tax receipts. The second pillar of the BEPS 2.0 project is attempting to install a minimum tax rate on multinationals. As yet it's still unclear how this would operate but suffice to say that this could impact Ireland's competitiveness which could in turn result in a decrease in investment.

With these proposals on the table you'd be forgiven for thinking that Ireland should walk away but the strong answer from official Ireland is that we are in favour of a multilateral solution but that it must be a solution that does not impact on the sovereignty of individual states. Looking at the alternatives of unilateral action across the globe you would have to agree with the Department's stance. It would also appear to be better to be included in the discussions rather than not. However, the most intriguing aspect of the current debate, from an Irish perspective, will be whether our position on local and international tax remains the same after, what could be significant, governmental change.

As we (at the time of writing) face into uncertainty over which of the three main parties will be able to form a government after an extraordinary election, it will be interesting to see how the stated tax policies of the new coalition partners will transition into a program for government.

Through various Fianna Fail and Fine Gael governments Ireland has had a steady and consistent approach to tax policy for nearly 50 years. A left leaning new regime could shake this up and the impact on our corporate receipts, good or bad, will be closely watched as new policies begin to take effect.

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