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Participation Exemption Feedback Statement
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5 September 2024

Second Feedback Statement on a Participation Exemption for Foreign Dividends

Dear Sir/Madam

The Irish Tax Institute welcomes the publication of the second Feedback Statement on a Participation Exemption for Foreign Dividends and the opportunity to engage with the Department on the design of the draft approaches to key elements of the legislation and to consider the necessary consequential amendments.

Background

As outlined in our response to the first Feedback Statement on a Participation Exemption for Foreign Dividends in May 2024,[1] we firmly believe that the rules governing the participation exemption for foreign dividends should be clear and simple with limited exceptions and have a broad territorial scope to achieve the objective set by the former Minister, Michael McGrath T.D. in April to *"give confidence and foresight to key stakeholders, maintaining Ireland's reputation as a business-friendly destination and encouraging companies to establish and expand their operations in Ireland."*[2]

[1] Irish Tax Institute, Response to Department of Finance Feedback Statement on a Participation Exemption for Foreign Dividends, 8 May 2024. https://taxinstitute.ie/wp-content/uploads/2024/05/2024-05-08-ITI-Response-to-the-Feedback-Statement-on-a-Participation-Exemption-for-Foreign-Dividends.pdf
[2] Department of Finance press release, 5 April 2024. https://www.gov.ie/en/press-release/a7303-minister-mcgrath-publishes-feedback-statement-on-participation-exemption-in-irish-corporate-tax-system-for-foreign-dividends/

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The Minister for Finance, Jack Chambers T.D., confirmed the introduction of a participation exemption is intended to deliver on the commitment to simplify the Irish corporate tax system and that this *"demonstrates Ireland's continued desire to promote a business environment that remains best in class. We are in a period of unprecedented change in the international taxation landscape, and enhancement of Ireland's tax system will provide stakeholders with the certainty and simplicity needed to continue to prosper in Ireland."*[3]

We believe there are a number of elements of the proposed legislative approach which should be reconsidered if the participation exemption is to fulfil the Minister's commitment to simplify the Irish corporate tax system and to promote a best-in-class business environment. The feedback we have received from our members is that the proposed legislative approach, as currently drafted, introduces unnecessary complexity and ambiguity into the participation exemption.

In particular, our members have stressed the narrow geographic scope combined with the requirement that the distribution must be made 'out of profits' and must not be in respect of a relevant subsidiary's 'redeemable share capital' as elements of the participation exemption which will significantly impact the practical application of the exemption.

As the Institute has previously highlighted, the implementation of the Pillar Two Minimum Tax Directive means that if Ireland is to compete for foreign direct investment, at a minimum, it must strive for a level playing field and align its corporation tax code with other EU Member States. Unfortunately, the participation exemption, as currently drafted, will not be competitive when compared to other EU/ EEA jurisdictions or jurisdictions with which Ireland has a double taxation agreement (DTA).

Geographic Scope

The Feedback Statement states that the geographic scope of the participation exemption currently remains at EU/EEA and tax treaty partner source jurisdictions. In our response to the first Feedback Statement in May 2024, we outlined that limiting the geographic scope of the participation exemption to dividends received from companies resident in the EU/EEA or jurisdictions with which Ireland has a DTA is too restrictive and is out of step with the approach adopted by many of Ireland's competitors for foreign direct investment.

At a minimum, we believe that the scope should be extended to include dividends paid by a company that is a constituent entity of the same Pillar Two group as the Irish recipient regardless of the location of the payor company. The profits of global subsidiaries of Irish companies in scope of the Pillar Two Global Anti-Base Erosion Rules (GloBE) Rules will be subject to a 15% minimum effective tax rate, in either the local jurisdiction or via another group company. As we set out in our response to the first Feedback Statement, it would therefore be reasonable for distributions received by an Irish company from subsidiaries in a

[3] Department of Finance press release, 27 August 2024. https://www.gov.ie/en/press-release/31a24-minister-chambers-publishes-2nd-feedback-statement-on-participation-exemption-in-irish-corporate-tax-system-for-foreign-dividends/

group which is in scope of the Pillar Two Rules to qualify for the participation exemption irrespective of where the subsidiary is resident for tax purposes.

The second Feedback Statement notes that a factor to be considered in relation to Pillar Two is for a jurisdiction's rules to meet a qualifying standard, they must not provide any benefits that are related to the rules (i.e., the no benefit requirement). We understand discussions are still ongoing at OECD Working Party meetings to agree interpretative guidance for this 'no benefit' rule. The Feedback Statement also notes that consideration is required of the EU Code of Conduct Guidance which indicates that foreign dividend exemption regimes may be harmful where profits giving rise to dividends have been taxed at a significantly lower level and have not been subjected to effective anti-abuse provisions or countermeasures.

The OECD Commentary[4] on the no benefit requirement states that "*changes to the domestic corporate tax rules consequent on the introduction of a domestic minimum tax should not be considered a benefit provided that they do not result in MNE Groups achieving overall tax outcomes that are inconsistent with the outcomes provided for under the GloBE Rules and their Commentary."* The overarching objective of the Pillar Two Rules is to ensure that in scope groups pay a minimum level of taxation on the income arising in each jurisdiction where they operate.

Therefore, an approach to the participation exemption which treats distributions received by an Irish company from subsidiaries in a group which is in scope of the Pillar Two Rules as qualifying for the exemption, irrespective of where the subsidiary is resident for tax purposes, would clearly be in line with the above stated objective. We do not believe that such an approach could give rise to any issues under the Pillar Two no benefit requirement nor indeed, the EU Code of Conduct Guidance.

It is worth noting that the new outbound payments defensive measures introduced in Finance (No.2) Act 2023 exclude payments within the charge to a qualifying Pillar Two top-up tax. It is therefore difficult to understand the concerns raised by policymakers now on relying on the protections afforded by Pillar Two to broaden the geographic scope of the participation exemption.

If policymakers believe it is not possible to fully consider any potential issues around broadening the geographic scope of the participation exemption at this time, given the ongoing discussions at the OECD regarding the no benefit requirement and the short time available before the publication of the Finance Bill, it would be essential that a firm commitment is provided by Government to businesses to revisit this important aspect of the participation exemption next year.

[4] OECD (2024), Tax Challenges Arising from the Digitalisation of the Economy – Consolidated Commentary to the Global Anti-Base Erosion Model Rules (2023): Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/b849f926-en, at page 256

Draft approaches to key elements of the legislation

We have set out in the section below our specific comments on the technical detail of the proposed legislative provisions for a participation exemption for foreign dividends, as outlined in the second Feedback Statement.

Subsection (1) - Definitions

Relevant distribution

The proposed definition of 'relevant distribution' refers to *"a dividend paid, or other distribution made, out of profits in respect of a relevant subsidiary's share capital other than redeemable share capital, that constitutes income in the hands of the recipient for the purposes of corporation tax, …"*

We believe the inclusion of the phrases **'out of profits'** and **'redeemable share capital'** are unnecessary; will significantly limit the uptake of the exemption; and make the exemption much less attractive than comparable participation exemptions in the EU. The Irish tax code already contains robust anti-tax avoidance provisions which can address any concerns policymakers may have about double non-taxation risks and therefore, we strongly urge that both of the abovementioned phrases are deleted from the definition of relevant distribution.

We have set out in further detail below on how the inclusion of these two phrases would impact the operation of the participation exemption in practice.

a. *Out of profits*

The existing provisions in Schedule 24 mean companies are required to undertake an administratively burdensome tracing exercise through layers of companies in order to identify the underlying tax incurred at each level on the distributions received. We consider that the inclusion of the phrase 'out of profits' in the definition of relevant distribution will introduce similar complexity to the new participation exemption as companies will be required to trace the year the profits from which a distribution is paid went through the income statement to satisfy themselves that the distribution was paid out of profits.

There are several scenarios where a company may not have profits in a particular year but will have cash to make a distribution. For example, foreign companies with historic losses may be able to pay a dividend from other reserves such as a share premium account. However, the 'out of profits' requirement would exclude dividends received from subsidiaries that do not have significant profits but may have reserves from the participation exemption.

Whether a payment is considered a distribution is a matter which is generally governed by company law in the payor jurisdiction and in some cases, may depend on the accounting standard which has been used. However, the proposed approach outlined in the second Feedback Statement does not appear to take this into account.

The term 'out of profits' is included in the Taxes Consolidation Act (TCA) 1997 in section 21B, which provides that certain foreign dividends received by companies will be chargeable to tax at the 12.5% rate of corporation tax instead of at the 25% rate. The dividends concerned are dividends received by a company out of the trading profits of the non-resident subsidiary.[5] The reference to 'out of profits' in this section is necessary to differentiate between the trading and non-trading element of the profits subject to the 12.5% rate. Therefore, the inclusion of the phrase 'out of profits' in section 21B has a specific function which we believe is unnecessary in the context of the participation exemption which concerns Case III foreign income.

We understand that the inclusion of the term 'out of profits' stems from the Parent Subsidiary Directive.[6] The stated aim of the Parent Subsidiary Directive is to exempt *"dividends and other profit distributions*" paid by subsidiary companies to their parent company from withholding taxes and eliminates the double taxation of such income at the level of the parent company. Furthermore, section 831 TCA 1997 which transposed the Parent Subsidiary Directive into Irish law, defines a distribution as *"income from shares or from other rights, not being debt claims, to participate in a company's profits, and includes any amount assimilated to income from shares under the taxation laws of the State of which the company making the distribution is resident."*

We believe the proposed inclusion of the phrase 'out of profits' makes the exemption unworkable in practice and we would strongly urge that it is removed. While a company may clearly be in scope of the participation exemption, the administrative burden for taxpayers in tracing profits and dividends paid in their subsidiaries so as to satisfy themselves that a distribution is made 'out of profits' would render the participation exemption too complicated for many taxpayers. Indeed, where a parent company does not have full ownership of a subsidiary, or where a subsidiary has recently been purchased, the parent company may not have the necessary information to determine if the distribution was made 'out of profits'.

In addition, where a dividend is partly financed from profits and partly from other funds, such as a revaluation reserve, it is unclear from the draft legislation if it is intended that the whole of the dividend would be excluded from the participation exemption.

b. *Redeemable share capital*

The intended meaning of 'redeemable share capital' is unclear as it is not defined in legislation. Redeemable share capital could potentially cover all forms of returnable share capital including, for example, treasury shares. It is notable that section 626B

[5] Non-resident company that is resident, in an EU Member State, in a country with which Ireland has a double tax treaty in force, in a county with which Ireland has signed a double tax treaty in force, in a county with which Ireland has signed a double tax treaty which has yet to come into force, in a country which has ratified the Joint Council of Europe\OECD Convention on Mutual Assistance in Tax Matters or in a non-treaty country where the company is owned directly or indirectly by a quoted company.

[6] Article 1, Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (Parent Subsidiary Directive)

TCA 1997 does not contain a similar requirement nor is it a consideration in the context of section 129 TCA 1997.

We understand that the inclusion of the term 'redeemable share capital' may be to ensure that distributions from debt are excluded from the participation exemption. However, we consider that the exclusions in paragraphs (c) and (d) in the definition of relevant distribution should provide the necessary protections against any potential disguised debt arrangements or any amount considered to be interest equivalent. Furthermore, the draft legislation provides that any distribution which has been deducted for tax purposes will be excluded in any case.

In our view, the inclusion of the term 'redeemable share capital' in the definition of relevant distribution adds unnecessary complexity and uncertainty to the exemption and should be removed.

c. *Exclusions in the definition of 'relevant distribution'*

Paragraph (a) in the definition of 'relevant distribution' refers to a distribution that has been, or may be, in any accounting period, deducted for the purposes of tax in any territory outside the State under the law of that territory. While the term *"in any accounting period"* has a specific meaning in Irish tax law, the use of the term in this context is unclear as it would not necessarily have the same meaning in a law of another foreign jurisdiction.

Paragraph (e) in the definition of 'relevant distribution' refers to *"any dividend paid or other distribution made by an offshore fund within the meaning of section 743."* As section 743 TCA 1997 deals with a material interest in offshore funds it may be preferable for clarity that this provision is amended so that it refers to an offshore fund within the meaning assigned to it by section 743(1).

<u>'Parent company' and 'relevant subsidiary'</u>

The proposed definitions of 'parent company' and 'relevant subsidiary' include the phrase *"without the possibility of being exempt or an option of being exempt,…"* This proposed wording could unintentionally exclude dividend income that may have been exempt for valid reasons from the participation exemption. Furthermore, it does not make sense if a foreign subsidiary could have potentially claimed an exemption in its foreign resident location, but it opts not to do so, that this prevents the Irish company claiming the Irish participation exemption on dividends from that subsidiary.

We understand the term *"without the possibility of being exempt or an option of being exempt"* may be intended to reflect the wording used in Article 2 of the Parent Subsidiary Directive. Notably Article 2 is based on an earlier Directive from 1990, i.e., Council Directive 90/435/EEC, and the term *"without the possibility of being exempt or an option of being exempt"* was also used in that Directive. We understand that the policy intention behind this wording at the time was to address the risk of double non-taxation in the context of tax transparent entities. Clearly the corporate tax landscape has altered significantly since 1990, with extensive reforms introduced as a result of the OECD base erosion and profit shifting

(BEPS) project, the EU Anti-Tax Avoidance Directives, and the implementation of the Pillar Two GloBE Model Rules across jurisdictions.

The inclusion of the phrase would also be problematic if it is intended that distributions from US LLCs will qualify for the participation exemption in the future. This is because a US LLC may “check the box” to elect how it should be classified for tax purposes. A similar consideration arises in the context of a German KG as it may be treated as transparent for tax purposes.

In our view, it is the subsidiary’s tax position rather than the nature of the profits in the other jurisdiction that should be relevant to the Irish tax resident recipient in claiming the participation exemption. We believe that the current drafting of the definitions of ‘parent company’ and ‘relevant subsidiary’ should be revised so that the requirement is to consider whether the subsidiary is exempt from tax and the obligation to determine if there is “*an option to being exempt”* should be removed.

Subsection (2) – Relevant participation

‘Ordinary share capital’

The conditions which must be met for a parent company to be regarded as having a relevant participation in a relevant subsidiary are outlined in subsection (2) of the proposed draft legislation. Subsection(2)(a)(i) requires that the parent company owns at least 5% of the relevant subsidiary’s ordinary share capital.

The meaning of the term ‘ordinary share capital’ may not be clear in the context of certain equity interests, such as US LLCs. As previously highlighted, if the participation exemption is to enhance the business environment in Ireland it is important that the exemption encompasses distributions paid in respect of equivalent or similar members’ interests to equity.

Policymakers could consider using a definition similar to ‘ownership interest’ for the purposes of the Pillar Two GloBE Rules and as reflected in Part 4A TCA 1997 as an alternative wording to what is contained in the second Feedback Statement.

Ordinary share capital that is ‘not redeemable’

Subsection (2)(a) requires that the parent company holds ordinary share capital that is ‘not redeemable’. As outlined above, the meaning of redeemable share capital is unclear as it is not defined in legislation and therefore, it could potentially be very wide covering all forms of returnable share capital.

Subsection (2)(b) – Intermediate company not resident in a relevant territory

Subsection (2)(b) provides that a holding of ordinary share capital in a relevant subsidiary shall not be determined by reference to share capital held through an intermediary company that is not resident in a relevant territory. While policymakers may wish to restrict the availability of the participation exemption to distributions received from EU/ EEA/ DTA

jurisdictions, the rationale for restricting the availability of the participation exemption where a relevant participation is held indirectly through a non-EU /EEA /DTA jurisdiction is completely unnecessary.

Based on the current drafting of the legislation, as Ireland is not considered a relevant territory, it would appear that in establishing a relevant participation a parent company would not be able to rely on its holding in an intermediary company resident in Ireland. We do not believe that this is intended and it should be reconsidered.

Subsection (3) - Participation exemption

Subsection (3) sets out the exemption from corporation tax which will apply where a relevant subsidiary makes a relevant distribution to a parent company. The exemption applies where the parent company would, but for the participation exemption, be chargeable to corporation tax in respect of the relevant distribution under Case III of Schedule D, except "*where otherwise provided by the Corporation Tax Acts*". The rationale for inclusion of the term "*where otherwise provided by the Corporation Tax Acts*" is unclear in this context and we would welcome clarity regarding the intended meaning.

Section 110 companies are carved out of the participation exemption in subsection (3)(b). The Institute acknowledges that the Department's review of the Funds Sector is ongoing, however, it is important that the position in respect of section 110 companies is considered.

Subsection (4) - Shareholding requirement

The Feedback Statement includes a shareholding requirement in subsection (4) which requires a parent company to hold a relevant participation in the relevant subsidiary for an uninterrupted period of not less than 12 months that includes the date on which the relevant distribution is made by the relevant subsidiary.

In our view, the shareholding requirement for the participation exemption should mirror the shareholding requirement in section 626B TCA 1997, which provides that a company will only qualify as a parent company at a certain point in time, if that time falls within an uninterrupted period of not less than 12 months throughout which it has held the 5% shareholding in the investee company, whether directly or indirectly. A disposal made during this period, or within the two years following the end of this period, may qualify for the share participation exemption in section 626B.

Subsection (5) - Anti-avoidance provision

The second Feedback Statement includes an anti-avoidance provision in subsection (5). The draft legislation includes new terminology that is not included in Ireland's existing comprehensive anti-avoidance legislation. The terms 'not genuine', 'valid commercial reasons' and 'economic reality' are not defined in the Irish tax code and will undoubtedly give rise to ambiguity for taxpayers.

As previously highlighted, Ireland's corporation tax code has robust base erosion protections, including the general anti-avoidance rule in section 811C TCA 1997, EU Anti-Tax

Avoidance Directive[7] (ATAD) compliant controlled foreign company (CFC) rules, recently extended transfer pricing rules, the Interest Limitation Rule (ILR) and anti-hybrid rules. Given these existing protections, we believe specifically inserting the proposed general anti-avoidance provision into the legislation for the participation exemption, which contains new and undefined terms, is unnecessary and would introduce complexity and uncertainty into the regime.

Consequential Considerations

The Feedback Statement notes consequential amendments to a number of other provisions in the TCA may be necessary. However, with the exception of the potential approach to the amendment of the CFC rules, no proposed approaches to the legislation have been provided. It is difficult to provide any meaningful feedback on the potential consequential amendments to the provisions outlined in the second Feedback Statement in the absence of draft legislation. In this regard, we would urge the Department of Finance and Revenue to continue to engage with stakeholders up to the publication of the Finance Bill to ensure the legislation, when published, is clearly understood by taxpayers, is operable in practice and does not give rise to unintended consequences.

Schedule 24 TCA 1997

The second Feedback Statement identifies certain sections/ Parts of the TCA 1997 that may interact with or be impacted by the introduction of a participation exemption, but at present it is not anticipated that legislative amendments to these provisions will be necessary.[8] One such provision is Schedule 24 TCA 1997.

The administrative complexity associated with claiming double taxation relief on foreign dividends under Schedule 24 is well documented and has been raised by the Institute on a number of occasions. As we have previously highlighted, Schedule 24 has been amended on a piecemeal basis over time since 1997 to reflect policy changes and European case law which has resulted in the operation of the relief for foreign credits becoming increasingly complex and administratively burdensome for taxpayers.

Given the limitations and the complexity of the proposed legislative approach to the participation exemption, outlined in the second Feedback Statement, in many cases companies will continue to rely on Schedule 24 as normal to claim relief from double taxation. Consequently, it is important Schedule 24 is amended to make the provisions easier to read and more straightforward to administer in practice.

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[7] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market

[8] These provisions relate to Section 83 TCA 1997 - Expenses of management of investment companies; Section 21B TCA 1997 - Tax treatment of certain dividends; Section 434 TCA 1997 - Close company surcharge; Part 26 TCA 1997 - Life Assurance Companies; Part 27 TCA 1997 - Unit Trusts and Offshore Funds; and Schedule 24 TCA 1997 - Double taxation relief for foreign taxes.

Conclusion

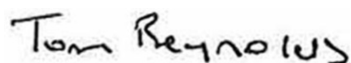
The introduction of a participation exemption for foreign dividends into Irish law represents an opportunity to maintain the attractiveness of Ireland as a location for investment. However, we consider the proposed approach to the participation exemption, as currently drafted, will not achieve the much-needed administrative simplification which business require and as a result, could negatively impact Ireland's position in competing for foreign direct investment at a time when other jurisdictions are strengthening their offerings.

We would urge that the key elements of the proposed approach, which we have outlined above, are reconsidered, so that the exemption can achieve the stated objective for Ireland to introduce a participation exemption which is best in class, competitive and simple to operate.

The first Feedback Statement noted that further engagement with stakeholders regarding a foreign branch exemption is expected in 2024, however, this is not addressed in the second Feedback Statement. As Ireland does not have a branch exemption at present, there can be significant differences in the timing and measure of taxable income for Irish companies between the head office and branches resulting in tax uncertainty and complexity. The introduction of a foreign branch exemption alongside the participation exemption for foreign dividends is important if Ireland is to remain an attractive location for foreign direct investment.

The Institute would be happy to engage further in this consultation through stakeholder meetings or direct discussions. Please contact Anne Gunnell of this office at agunnell@taxinstitute.ie if you require any further information in relation to this submission.

Yours sincerely



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