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Minister Paschal Donohoe TD

Department of Finance

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Upper Merrion Street

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26 July 2017

Budget 2018 and Finance Bill 2017 submissions

Dear Minister

I attach for your information, our Budget 2018 Submission, which contains the key details from our report on the indigenous sector, *A future tax strategy to grow Irish indigenous exports.* I understand from my colleagues at the Institute that you received a copy of the full report some weeks ago.

In addition, we also set out a number of technical and legislative proposals for consideration as part of your Finance Bill deliberations.

We would very much welcome a meeting, as indicated, with you and your officials to discuss these matters in advance of the Budget.

Yours sincerely

President
Irish Tax Institute

Directors: Mark Barrett – President, Brian Brennan, Marie Bradley, Colm Browne, Dermot Byrne, Sandra Clarke, Ian Collins, Ciaran Desmond, David Fennell, Karen Frawley, Ronan Furlong, Johnny Hanna, Jim Kelly, Aoife Lavan, Frank Mitchell, Tom Reynolds, Kieran Twomey, Shane Wallace, Martin Lambe (Chief Executive). Immediate Past President – Mary Honohan.

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Summary of Recommendations

Our recommendations for Finance Bill 2017 focus on the nine key areas below, further details of which are provided in the body of the submission.

1. **Companies Act 2014**: It is three years since Companies Act 2014 was passed, providing a new legislative framework for mergers and divisions. However, changes to tax legislation have not been implemented to match the company law changes, thereby resulting in tax uncertainty, which is impacting on commercial transactions. Amending legislation is urgently required in Finance Bill 2017 to ensure the alignment of tax and company law.

2. **Direct Demergers**: In recent times, there has been an increase in group restructuring activity, including demergers. A direct demerger can be implemented via an income distribution process or a capital reconstruction, however, the tax outcomes for shareholders are different even though the commercial result of the demerger for the shareholders is the same.

   The Institute recommends that Finance Bill 2017 removes this differentiation. Each shareholder should be treated for capital gains tax purposes, as if the shares transferred to them, by way of a direct demerger, are acquired by them at the same time as they acquired the original shares in the parent company and for an appropriate portion of the consideration for the original shares in that company.

3. **Revised Entrepreneur Relief**: Revised Entrepreneur relief (as interpreted in Revenue's Operational Manual), contains four significant limitations:

   - where a dormant company is present in the group;
   - where the group is party to a joint venture;
   - where the group/company holds investments; and
   - where the group/ company leases out part of its premises.

   We recommend that section 597AA TCA 1997 is amended to remove restrictions to Revised Entrepreneur Relief in situations where a group holds a dormant company or has a shareholding in a joint venture company of less than 51%. The legislation should also be amended to allow for either an apportionment of relief when a company holds investments or earns rental income or

alternatively full relief to be claimed provided such activities fall below a certain level.

4. **Professional Subscriptions**: To remove the uncertainty in the application of guidance in the area of professional subscriptions, we recommend that Revenue be given the power under section 118 TCA 1997 to compile a list of approved professional bodies, subscriptions to which would not be a taxable benefit if paid by an employer. This would be similar to the list system that currently operates in the UK.

5. **Employment Investment Incentive**: Companies carrying out R&D work for prolonged periods prior to trading are currently experiencing some uncertainty about the availability of EII. Under the predecessor to EII (the Business Expansion Scheme – BES), R&D was recognised as a qualifying trade in its own right and therefore these concerns for companies in sectors such as MedTech did not arise. We recommend that EII legislation adopts a similar approach to its predecessor (BES relief), to prevent the difficulties that are currently arising for these companies.

   Feedback from our members also suggests that the introduction of the General Block Exemption Regulations into EII legislation is causing significant problems for companies seeking follow-on investments. This arises even within 7 years of the businesses beginning to trade and we would suggest that a full review of the scheme is required to address these concerns.

6. **Dwelling House Relief:** We recommend that an amendment be made to subsection 9(c) of section 86 of the Capital Acquisitions Tax Consolidation Act 2003 as follows:
   "Where a dependent relative takes a gift **<u>or inheritance</u>** of a dwelling house, paragraph (a) of subsection (2) shall not apply for the purposes of determining whether the dwelling house is a relevant dwelling house."

7. **VAT deferral licence for importers**: With the UK indicating that one of its options could be to leave the European Single Market and Customs Union as part of the Brexit process, we believe the State should consider introducing an Irish VAT deferral licence regime for importers, similar to the regime that currently operates in the Netherlands.

8. **Proportionality of interest and penalties:** In the Institute's view, the rate of interest imposed on the late payment of tax should reflect the actual cost to the Exchequer and be tracked to

prevailing ECB market rates. Penalties for the late filing of iXBRL financial statements and for RCT payment errors, should be fixed penalties rather than tax-geared/payment geared penalties respectively. It is also very important that careful consideration be given to the proportionality of interest and penalties that may apply on the introduction of the new 'real-time' PAYE regime for employers from 1 January 2019.

9. **Section 79C TCA 1997:** We recommend a number of technical adjustments to section 79C TCA 1997 to address some unintended consequences that have arisen in the operation of the legislation.

Key areas to be addressed in Finance Bill 2017

1. Companies Act 2014

The Companies Act 2014 was passed three years ago, its purpose was to consolidate existing Irish company law and update it to reflect modern business transactions. The Act introduced a new legislative framework to deal with mergers and divisions for private companies incorporated under Irish law.

However, Irish tax legislation still does not cater for these new concepts and significant concern prevails as to whether, on a technical reading of the tax legislation, companies can avail of certain tax reliefs which would typically have been available for mergers and divisions in the past.

Clarity on taxation is urgently needed for companies involved in such transactions and it is important that Finance Bill 2017 updates the relevant tax legislation to ensure its alignment with the Companies Act.

Institute Recommendation:

Finance Bill 2017 needs to contain extensive amending legislation to reflect the new company law framework contained in the Companies Act 2014. The legislation that needs to be updated includes, but is not limited to;

Taxes Consolidation Act 1997

- Sections 584 – 587
- Section 615
- Section 633D

Stamp Duty Consolidation Act 1999

- Section 80
- Section 87B

2. Direct Demergers

On an issue related to the Companies Act changes, there has been an increase in group restructuring activity, including demergers. Publicly quoted and privately-owned groups often wish to separate divisions within the group to allow shareholders to invest independently in different companies within the group or to give a division the opportunity to grow in a new environment that is separate from the parent company's history and corporate image.

A direct demerger can be implemented under Irish law by a parent company transferring its shares in a subsidiary to its shareholders. However, this is deemed to be an income distribution for Irish tax purposes, subject to income tax, USC and PRSI. The dividend withholding tax implications of the deemed income distribution arising on a demerger are difficult to navigate, as the distribution of shares in the subsidiary is in a non-cash form and therefore, must be re-grossed and funded by the parent company.

Alternatively, a capital reconstruction can be implemented to achieve a demerger. A new company is incorporated which issues shares to the shareholders in return for the parent company transferring its shares in the subsidiary to the new company. Irish tax resident shareholders can avail of reorganisation relief,[1] so that there is no disposal for CGT purposes. The shareholders are deemed to acquire the shares in the subsidiary at the same time as their original shares in the parent company and the original base cost of the shares is apportioned between their shares in the parent company and the new shares in the subsidiary.

The tax outcomes for shareholders are different depending on whether the demerger is implemented by way of an income distribution or a capital reconstruction, as described above, even though the commercial result of the demerger for the shareholders is the same.

In contrast, the UK does not differentiate between demergers implemented either by way of an income distribution or a capital reconstruction, provided certain conditions are met.[2] Instead, the transaction is treated as falling within the UK reorganisation rules, so that the shareholders' original base cost in the shares of the parent company is apportioned between its shares in that company and the shares it receives in the subsidiary, as a result of the demerger. There is no disposal of the

[1] Section 587 TCA 1997
[2] Section 1075 Corporation Tax Act 2010

shares in the parent company for UK tax purposes.

Institute Recommendations:

- We recommend that Finance Bill 2017 removes the differentiation between direct demergers that are implemented via an income distribution and a capital reconstruction.

- Each shareholder should be treated for capital gains tax purposes, as if the shares transferred to them, by way of a direct demerger, are acquired by them at the same time as they acquired the original shares in the parent company and for an appropriate portion of the consideration for the original shares in that company.

3. Revised Entrepreneur Relief

The Institute's Budget submission (attached) contains a range of policy recommendations to improve the competitiveness of Ireland's Revised Entrepreneur Relief.

In addition to these policy recommendations, there are issues with the current legislation[3] (as interpreted in Revenue's Operational Manual),[4] which are limiting its use in three significant situations:

a) where a dormant company is present in the group;
b) where the group is party to a joint venture;
c) where the group/company holds investments and leasing of trading premises.

a) A dormant company is present in the group

According to Revenue's Operational Manual, Revised Entrepreneur Relief is not available in situations where a dormant company is present in the group. This is a very significant limitation to the relief because a subsidiary company can commonly become dormant over time. This might happen where the company has ceased to trade or where the trade has been transferred to another group company and the company cannot be wound up or liquidated due to company law legislation

[3] Section 597AA TCA 1997
[4] Revenue Operational Manual 19.06.02B – Capital Gains Tax Revised Entrepreneur Relief

for the protection of creditors. A group company could have dozens of trading subsidiaries, out of which only one is dormant, yet the relief is completely denied to the entrepreneur in this situation.

b) The group is party to a joint venture;

One of the conditions of Revised Entrepreneur Relief is that all subsidiaries must be minimum 51% subsidiaries for the relief to apply. If a group is party to a joint venture and holds less than 51% of the joint venture company, this again can result in full denial of the relief.

c) The holding of investments and leasing of trading premises

When either the holding of investments or the leasing of trading premises take place within a group company, this can exclude an entrepreneur from claiming Revised Entrepreneur Relief.

In the current low interest rate climate, it is common for businesses to invest cash generated from trading activities rather than leaving it on deposit – this results in them holding investments. Similarly, many companies who expect high growth in the short-term will often buy or lease premises that exceed their current needs but will meet their future expectations. These businesses will occasionally rent the excess space out to a third party until they need to expand into the space. Both these activities are efficient from a commercial perspective. They improve cash flow, while utilising the companies' assets to their full potential. Yet they can impact on this important tax relief.

We would ask that consideration be given to either apportioning relief in circumstances where there is a mix of investments and qualifying activities (similar to the retirement relief provisions[5]) or to allowing the relief in full where non-trading activities are below a certain de-minimus level. This is the approach adopted in the UK, where Entrepreneur's Relief is available on the sale of shares in a holding company, provided non-trading activities in the group do not comprise of more than 20% of the group's overall activities.

[5] Section 598 TCA 1997

Institute Recommendations:

- We recommend that section 597AA TCA 1997 is amended to remove restrictions to Revised Entrepreneur Relief in situations where a group holds a dormant company or has a shareholding in a joint venture company of less than 51%.

- The legislation should also be amended to allow for either an apportionment of relief when a company holds investments or earns rental income or alternatively full relief to be claimed provided such activities fall below a certain level.

4. Professional Subscriptions

Section 118 TCA 1997 was amended in 2011, so that the payment of a subscription to a professional body by an employer on behalf of an employee is treated as a taxable benefit-in-kind (BIK), subject to PAYE, PRSI and USC.

Revenue has issued guidance[6] on the matter which confirms that no BIK will arise, provided one of the following three tests is met:

a. There is a statutory requirement for membership of a professional body or there is a statutory right for a member to plead or be heard before a court/tribunal by virtue of their membership and the duties of their employment requires this.
b. There is a requirement for a practising certificate or licence to carry out their employment.
c. The duties of the employee and employment require the exercise of an occupation/profession which the annual fee refers to and the employee exercises that profession/occupation and membership of the professional body is an indispensable condition of the tenure of the employment.

This Guidance reflects the unique role that professional subscriptions play in providing access to certain professions and ensuring best practice standards and Continuing Professional Development requirements are met.

However, difficulties are arising in practice with the payment of some subscriptions which do not fall into any of the three categories listed above. This can happen, in particular where the subscription being paid relates to a second (but often very relevant) qualification held by the employee.

[6] eBrief 19/2011

In the UK, professional subscriptions are not subject to BIK, where they are paid by an employer to a body approved by HMRC. HMRC maintains a statutory list of approved bodies on its website.[7] HMRC approval is based on the activities of the body being of direct benefit to the profession in question and practiced in the performance of the duties of the person's employment.[8] As an example, the Irish Tax Institute is on this HMRC list and therefore any subscriptions paid on behalf of our members are not subject to BIK for the purposes of UK tax law.

Institute Recommendation:
To address the current uncertainty in this area, we are seeking the introduction of a new power under Irish legislation enabling Revenue to compile a list of approved professional bodies, subscriptions to which would not be treated as a taxable benefit if paid by an employer.

5. Employment and Investment Incentive

The EII provides income tax relief to individuals who make equity investments in qualifying trading companies. It is a welcome income tax relief that encourages diversification of funding for companies that qualify, however it has some limitations. Again, we have set out a number of possible enhancements that could be made to the relief in our attached Budget submission (Recommendations 16 to 18).

In addition, the current EII regime is leading to some difficulty in sectors where a prolonged period of R&D activity typically takes place before trading can begin. The MedTech sector is a particular case in point and companies in this sector should be ideal candidates for EII relief. Their activities are labour intensive, leading to significant employment creation, growth of supplier companies and the development of technology that can be scaled, commercialised and internationally traded.

For EII relief to apply, the company in question must generally be trading. There is a recognition in the legislation that companies in an early R&D phase may not yet be trading, but they can still qualify for the relief, provided:

- they begin to trade within two years of issuing the EII shares, or

[7] https://www.gov.uk/government/publications/professional-bodies-approved-for-tax-relief-list-3
[8] Section 344, Income Tax (Earnings and Pensions) Act 2003 – See Appendix 2 for extract of legislation.

- the company sells an intangible asset (which was a result of the R&D activities) to another company to use in their trading activities.

The difficulty for companies in sectors such as MedTech is that they will often not have begun to trade within two years. Withdrawal of EII relief can arise in these circumstances because the company has continued to undertake R&D beyond the two-year period, without beginning to trade.

Under the old BES system, R&D was recognised as a qualifying trade in its own right and therefore concerns about prolonged R&D periods did not arise. We recommend that EII legislation adopts a similar approach to its predecessor (BES relief), to prevent the difficulties that are currently arising for companies, particularly in the important MedTech sector.

On a related matter, feedback from our members would indicate that the application of the General Block Exemption Regulations is causing significant problems for companies seeking follow-on investment, even where this arises within 7 years of the business beginning to trade.

Institute Recommendations:

- Under the BES system, R&D was recognised as a qualifying trade in its own right and therefore concerns about prolonged R&D periods did not arise. We recommend that EII legislation adopts a similar approach to its predecessor (BES relief), to prevent the difficulties that are currently arising for companies, particularly in the important MedTech sector.

- Feedback from our members is that the introduction of the General Block Exemption Regulations into EII legislation is causing significant problems for companies seeking follow-on investments, even within 7 years of the businesses beginning to trade and we would suggest that a full review of the scheme is required to address these concerns.

6. Dwelling House Relief

Dwelling House Relief provides an exemption from Capital Acquisitions Tax (CAT) on certain gifts and inheritances of houses. Finance Act 2016 introduced changes to the criteria for the relief. Where an individual (disponer) **gifts** a house to a dependent relative, that disponer is not required to have lived in the house for the three years before the date of the gift. However, where a house is **inherited** by a dependent relative of the disponer, the disponer must have lived in that house as his/her only or main residence at the time of the inheritance. Thus, there is a disparity between the

treatment of gifts and inheritances.

For example, if parents of an incapacitated child decide to purchase a specially designed house for the child to live in, gifting it to the child after three years, dwelling house relief will apply to the gift. However, if the same parents opt to continue to live in their own home and instead of gifting the new house to their incapacitated child, they leave it to the child in their Will, no dwelling house relief will be available on the inheritance, even if the child has lived there for more than three years.

Institute Recommendation:

We recommend that an amendment be made to subsection 9(c) of section 86 of the Capital Acquisitions Tax Consolidation Act 2003 as follows:

"Where a dependent relative takes a gift **or inheritance** of a dwelling house, paragraph (a) of subsection (2) shall not apply for the purposes of determining whether the dwelling house is a relevant dwelling house."

7. VAT deferral licence for importers

In light of a possible Brexit, consideration could be given to introducing a VAT deferral licence regime for importers, should the UK leave the European Single Market and Customs Union.

The importation of goods into Ireland from outside the EU is a taxable event for Irish VAT purposes and Irish VAT must be paid at the time of importation. The Netherlands has introduced a special import VAT deferral regime (known as an Article 23 licence) for taxpayers with non-EU imports, which results in a cash flow benefit for them. An 'Article 23 licence' in the Netherlands allows a business to account for the VAT on imported goods in its Dutch VAT return under the reverse-charge mechanism, instead of paying the import VAT at the time of importation. The ability to defer the time at which import VAT must be accounted for without affecting the transportation of the goods, provides a clear cash flow benefit to importers in the Netherlands.

In general, the following conditions must be fulfilled to apply for the VAT deferral licence under the Dutch VAT system;

- the applicant must be resident or have a permanent establishment or a fiscal representative in the Netherlands;
- the applicant must import goods on a regular basis and
- the applicant must keep clear administrative records of the imported goods.

Institute Recommendation:

With the UK indicating that one of its options could be to leave the European Single Market and Customs Union as part of the Brexit process, we believe the State should consider introducing an Irish VAT deferral licence regime for importers, similar to the regime that currently operates in the Netherlands.

8. Interest on underpaid tax and penalties

The Institute fully appreciates the rationale for charging interest and imposing penalties on late filings. However, there are two important areas where we believe the level of sanction imposed is disproportionate to any error made.

i. *Interest on delayed payment of tax*

Interest is charged on the late payment of tax in Ireland at annualised interest rates of 8% and 10%, far in excess of the Irish mean overdraft rate, which was 2.4%[9] in 2016. In contrast, HMRC in the UK currently imposes interest at a rate of 2.75%, i.e. 2.5% above the current Bank of England Base Rate of 0.25%.[10] In applying the UK interest penalty regime the rate applied by HMRC is tracked at 2.5% above BoE base rate.

This is an issue that the Institute has raised on a number of occasions in the past but continues to be challenging for taxpayers. It is right and proper that interest should be imposed to recompense the Exchequer for the time delay in receiving any underpayment of tax and provide a level playing field for taxpayers who do not pay on time. However, current high levels of interest charged on the late payment of tax in Ireland far outweigh the cost to the State and, in some cases, are causing

[9] National Competitiveness Council Report: Cost of Doing Business in Ireland 2017, June 2017, p. 48
[10] http://www.bankofengland.co.uk/Pages/home.aspx

considerable hardship. The Government has been using best endeavours to reduce interest rates charged by commercial banks, in line with rates set by the European Central Bank and we believe the same principles should be applied in this instance.

ii. *Penalties*

There are two areas of the penalty code which we believe are disproportionate in their effect, namely penalties for late filing of iXBRL accounts and certain penalties relating to Relevant Contracts Tax (RCT) payments. In both instances, the penalties were introduced as part of major initiatives in recent years to digitise the tax system.

Large corporates who do not qualify for audit exemption[11] are required to file financial statements in iXBRL format within three months of the corporation tax deadline for the tax year concerned. Preparing iXBRL accounts is a difficult and time-consuming process.

The penalty for any later filing of iXBRL accounts is based on the total underlying tax liability, rather than being a fixed charge penalty. If iXBRL accounts are submitted late, a surcharge of 10 percent is imposed on the corporation tax liability, even where a company has filed its corporation tax return and paid its corporation tax liability in full and on time. For example, if a company has a corporation tax liability of €500,000 which it pays on time but files its iXBRL accounts for the accounting period a week after they are due, a surcharge of €50,000 will be imposed.

In our view, the imposition of the 10 percent surcharge on companies that have a strong compliance record for filing corporation tax returns and making tax payments on time is not proportionate to the administrative error made. This is particularly harsh when the taxpayer has filed its tax return and paid the tax liability on time with no loss to Revenue.

In contrast, the penalty in the UK is £200 if the return is filed within 6 months of the deadline. After this date, a tax-geared penalty applies, but it is levied on the tax outstanding, rather than the total tax liability.

[11]A company will qualify for audit exemption it its Balance Sheet Total does not exceed €4.4m and its turnover does not exceed €8.8m and its average number of employees does not exceed 50.

When RCT was moved to an online system, a "payment geared" penalty of between 3 and 35 percent, was introduced to apply to certain payments made by principal contractors to sub-contractors in the construction sector. A further penalty of €3,000 can also apply for not following correct RCT procedures. In this case, a penalty regime that is based on the total payments made rather than the RCT liability is also disproportionate.

The matter of proportionality of interest and penalties is particularly important in light of the introduction of the new 'real-time' PAYE regime for employers from 1 January 2019 – a transition that will be very challenging for taxpayers.

Institute Recommendations:

- The rate of interest imposed on the late payment of tax should reflect the actual cost to the Exchequer and be tracked to prevailing ECB market rates.

- Penalties for the late filing of iXBRL financial statements and for RCT payment errors, should be fixed penalties rather than tax-geared/payment-geared penalties respectively.

- Consideration should also be given to the proportionality of interest and penalties given the introduction of the new 'real-time' PAYE regime for employers from 1 January 2019.

9. Section 79C TCA 1997

Section 79C TCA 1997 provides that gains or losses arising from the disposal of foreign currency held in an Irish bank by certain holding companies are chargeable to corporation tax as Schedule D Case IV income rather than CGT. To prevent a consequent loss to the Exchequer, the amount of any currency gain brought into the charge to corporation tax is increased so that the tax payable equates to the tax that would have been payable if CGT had applied.

However, there are several technical adjustments that we recommend should be made to section 79C to remove, what we believe to be, unintended consequences within the legislation.

Institute Recommendations:

The following technical adjustments should be made to section 79C 1997 to remove unintended consequences of the legislation;

- Some concerns have arisen that gains chargeable to Schedule D Case IV could be subject to the close company surcharge under section 434 TCA 1997. To remove this doubt, we recommend that a new sub-section 7 be inserted into section 79C TCA 1997 as follows: *"Any income chargeable under Case IV of Schedule D by virtue of this section shall not be taken into account in computing 'investment income' for the purposes of section 434*."

- Where a group operates in a functional currency other than euros and it transacts only in that currency, there is uncertainty over the applicability of s79C in cases where that group does not have a wholly owned subsidiary. We recommend that section 79C(1)(b) TCA 1997 be amended to address this issue.

- There is also some uncertainty over whether section 79C applies to a holding company that holds foreign currency bank accounts but indirectly holds trading subsidiaries. Again, the section needs to be reviewed to deal with this matter.

A detailed tax analysis of each of the issues is attached at Appendix 2.

Appendix 1

Section 344 Income Tax (Earnings and Pensions) Act 2003

344 Deduction for annual subscriptions

(1) A deduction from earnings from an employment is allowed for an amount paid in respect of an annual subscription if—

(a) it is paid to a body of persons approved under this section, and

(b) the activities of the body which are directed to one or more of the objects within subsection (2) are of direct benefit to, or concern the profession practised in, the performance of the duties of the employment.

(2) The objects are—

(a) the advancement or dissemination of knowledge (whether generally or among persons belonging to the same or similar professions or occupying the same or similar positions),

(b) the maintenance or improvement of standards of conduct and competence among the members of a profession,

(c) the provision of indemnity or protection to members of a profession against claims in respect of liabilities incurred by them in the exercise of their profession.

(3) The Inland Revenue may approve a body of persons under this section if, on an application by the body, they are satisfied that—

(a) the body is not of a mainly local character,

(b) its activities are carried on otherwise than for profit, and

(c) its activities are wholly or mainly directed to objects within subsection (2).

(4) The Inland Revenue must give notice to the body of their decision on the application.

(5) If the activities of the body are to a significant extent directed to objects other than objects within subsection (2), the Inland Revenue may—

(a) determine the proportion of the activities directed to objects within subsection (2), and

(b) determine that only such corresponding part of the subscription as is specified by the Inland Revenue is allowable under this section.

(6) In determining that part, the Inland Revenue must have regard to the proportion of expenditure of the body attributable to objects other than objects within subsection (2) and all other relevant circumstances.

(7) If a body applies for approval under this section and is approved, a subscription paid to it—

(a) before it has applied but in the same tax year as the application, or

(b) after it has applied but before it is approved, is treated for the purposes of this section as having been paid to an approved body.

Appendix 2

Section 79C TCA 1997

There are several technical adjustments required to section 79C 1997 to remove unintended consequences of the legislation. Section 79C allows gains or losses arising from the disposal of foreign currency held in an Irish bank by certain holding companies to be chargeable to corporation tax rather than Capital Gains Tax (CGT). We have set out below a tax analysis of four issues relating to the application of section 79C which are causing difficulties in practice.

1. Potential application of close company surcharge

Section 79C TCA 1997 provides that foreign currency gains realised on bank deposits by certain holding companies should be credited to the company's profit and loss account and subject to corporation tax under Schedule D, Case IV. The question arises as to whether the assessment to tax under Schedule D, Case IV means that this income should be regarded as 'investment income' for the purposes of computing the close company surcharge under section 434 TCA 1997.

The definition of 'investment income' under section 434 requires it both to have the character of income and be regarded as earned income if received by an individual. The mechanism to tax the foreign currency gains on deposits under section 79C applies only to companies and would not appear to change the character of the gains under first principles.

This is reaffirmed by the fact that the amount which is measured under section 79C and assessed to tax under Schedule D, Case IV is a re-grossed amount, which is designed to achieve an effective tax rate on the Case IV sum that mirrors the CGT rate of 33 percent on the gain arising and recognised in the income statement of the company.

If foreign currency gains that are assessable to tax for holding companies under Schedule D, Case IV would be considered 'investment income' for the purposes of section 434, the net effect of the introduction of section 79C would be an increased tax cost, as such gains were not subject to the surcharge under the previous applicable CGT regime.

We believe that it would be useful to amend the legislation to ensure that income chargeable under Schedule D Case IV is not inadvertently subject to the close company surcharge.

2. Definition of a relevant holding company

Section 79C TCA 1997 provides that there must be a 'relevant holding company' for a potential CGT charge not to arise on a technical gain every time there is a movement out of a foreign currency bank account. If a holding company does not have at least one wholly owned subsidiary carrying on a trade at the time of the first withdrawal from a foreign currency bank account, it needs to rely on part (b) of the definition of a 'relevant holding company' in section 79C (1).

Part (b) of the definition defines a relevant holding company as a company "*which acquires or sets up, within one year of a net foreign exchange gain being credited to its accounts, a wholly-owned subsidiary which derives the greater part of its income from trading activities.*"

To qualify under part (b) there must be a 'net foreign exchange gain', which is defined as the excess of foreign exchange gains over foreign exchange losses on the disposal of currency in a relevant bank deposit by a relevant holding company. Until it is established that a company is a relevant holding company and thus holds a relevant bank account, it is unclear if there would be any net foreign exchange gain. The circular reference can only be resolved by assuming that a company will eventually be a relevant holding company under (a) of the definition to establish that it is actually a relevant holding company initially under (b).

The issue arises as to whether a relevant holding company can exist by reference to part (b) of the definition of 'relevant holding company' where the company transacts only in its functional currency. While there may be a gain under CGT rules (absent the application of section 79C), there is no gain that is credited to the accounts. This reflects the fact that there is no real gain as computed in the currency with which the company primarily operates.

Given that the existence or otherwise of amounts credited to the profit and loss account can only be established for certain after accounts are prepared, we would recommend that the legislation is amended to reflect the 12-month period to begin from the end of the accounting period in which the disposal of currency occurs.

3. Holding company that holds bank assets but indirectly holds trading subsidiaries

There is uncertainty over whether section 79C TCA 1997 applies in circumstances where a holding company, holds various currency bank accounts but is a holding company which indirectly holds trading subsidiaries (through its immediate wholly owned subsidiary). The holding company

subsidiary directly holds the trading subsidiaries which means that the top holding company indirectly meets the test set out in the section.

The definition of ‘wholly owned subsidiary’ in section 79C refers back to section 9 TCA 1997, which requires that a ‘wholly owned subsidiary’ for the purposes of the Taxes Acts is directly owned. We believe that a holding company which holds its interests in trading subsidiaries through its wholly owned subsidiary (which is a qualifying holding company) should be able to apply the provisions in section 79C, where it (rather than its holding company subsidiary) holds the bank account assets. It is not uncommon for a top holding company in Ireland to have an immediate subsidiary holding company, which in turn, holds the operating trading companies within the group.