Investing in Ireland

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Proposed US tax changes – impact for Ireland?

Monday, 5 May 2009 saw the announcement by President Obama of a number of proposed tax changes that will impact on how US MNCs are taxed in respect of their non-US earnings. While not repealing deferral as some had feared, these changes, to the extent legislated for as broadly proposed, are likely to influence how US MNCs structure their existing and future foreign investments.

A summary of the proposed changes, as well as some initial thoughts on the likely impact for Ireland, is set out below. Please do not hesitate to contact me, or your usual PwC contact, if you would like to discuss this matter further.

Overview

Against the background of a rapidly increasing US budgetary deficit, President Obama announced a number of proposed tax changes on 5 May last.

Under the headline of “Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas”, these proposals are designed to raise $210bn in additional US tax revenue over a 10 year period starting in 2011.

The proposals will have an impact on US companies and their international structures. It is important, however, to be clear about what the proposals will do, and will not do, and why this is relevant to Ireland.

The low tax rate in Ireland is of value to US MNCs because the US tax system does not tax the profits of a foreign subsidiary (e.g. an Irish subsidiary) until the income is paid up to the US, typically by way of dividend. At this point, it is taxed at the US rate of 35% (typically with a credit for the Irish taxes paid on the same income).

The "deferral" of US tax pending repatriation is, therefore, key to the value of the low Irish tax rate for US MNCs.

There has been much debate in the US in recent months on the subject of a possible repeal of deferral. This would be a significant change and one with serious negative consequences for US investment in Ireland, as it would virtually eliminate the value of the low tax rate.

President Obama’s proposed changes provide for a number of amendments to deferral, but critically do not provide for its repeal. This means that US companies should continue to be able to benefit from Ireland’s low tax rate, which is of central importance.

The backdrop for much of the discussion in the US regarding foreign tax changes has been focussed on tax havens, tax evasion, and “inappropriate” tax planning.

President Obama has several times referred to unacceptable tax scams involving tax havens, and there have been significant discussions with a number of countries regarding banking secrecy and the role which it may play in facilitating tax evasion by US and other citizens.

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There is also a significant economic impetus – tax increases are required to fund spending plans and increasing budgetary deficits.

The proposed measures are generally focused on these areas of concern, and can be summarised as follows:

- **Expense allocation**

  The US tax system allows a deduction (against US taxable income) for certain expenses incurred where the expense relates to a foreign subsidiary. This might include, for example, interest costs on borrowings used to fund an overseas investment.

  The proposed change is intended to restrict the amount of the deduction available to the proportion of foreign income which has actually been subject to US tax. The rationale is to seek to ensure that a deduction is only allowed to the extent that there is corresponding income to be taxed.

- **Foreign tax credit calculations**

  The US rules for calculating the amount of the credit allowed against US tax for foreign taxes paid when foreign income is taxed in the US are complex, and the proposals set out to tighten the rules to prevent abuse.

  There are also indications that the changes may provide for a more general streamlining of the tax credit system, for example by treating all foreign income as having been subject to the average foreign tax rate suffered on that income.

  This would be a significant change, and would constrain companies in their ability to manage dividend flows from high and low taxed countries.

- **"Check-the-box" planning**

  It is possible under US tax rules to make an election (to "check the box") to determine whether or not a foreign entity is treated as a corporation for US tax purposes, or alternatively as a look through entity. The objective is to facilitate flexibility to transfer activities between related entities without triggering an unintended tax cost.

  However, there is a perception that these rules have been used to facilitate tax structuring which is considered unacceptable, particularly where it involves tax havens, and the proposals suggest at a minimum a restriction (or possibly even repeal) of these check-the-box rules.

  This will create some uncertainty, and will likely require some US companies which use the current rules for cross-border planning to re-visit their current structures.

- **Tax havens**

  Although there is a strong general emphasis on tax havens in the thrust and tone of the proposals, the specific provisions are more narrowly focussed on individuals, and seek to ensure that US citizens will not be able to evade taxes by using tax havens as a means of non-disclosure

- **Increased IRS resources**

  President Obama announced the hiring of nearly 800 new IRS staff to focus on "international enforcement", focussing on tax evasion and avoidance, transfer pricing, and financial products and transactions.

Conclusion

Given the position of strength of President Obama and the Democrat controlled Senate and Congress, these changes might be expected to materialise along the lines proposed.

The proposals face considerable opposition, however, from US MNCs and business groups such as the US Chamber of Commerce. It will be interesting to see whether the proposals are diluted or amended in any way as they work their way through Senate and Congress

Ireland's commitment to our 12.5% tax rate, our recently improved R&D tax credits, as well as the new IP tax deduction rules expected to be included in tomorrow's Finance Bill (details to follow on this) should, however, ensure that Ireland remains well placed as a favoured investment location for US MNCs.