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PwC Ireland Financial Services Tax Group

PwC is a leading provider of tax services to business in Ireland's IFS sector. This group provides advice and news on Irish and international tax issues - and tax-related business issues - affecting IFS businesses in Ireland. Specialisms within the group include banking, treasury, asset finance, securitization, insurance, and investment management.

For issues relating to this new alert please contact your usual PwC contact or the specialists listed at the end of this article.

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EU tax developments may favour Irish companies.

Introduction

The European Court of Justice ('ECJ') now has a prominent role in direct tax matters with accelerating numbers of cases decided and pending. These cases are having a profound effect on the direct taxation of EU residents. The taxpayer usually wins and the Member State concerned must prospectively alter its legislation and compensate the taxpayer.

Taxpayers continue to challenge tax laws providing for differential treatment in cross-border situations as being discriminatory under the EC Treaty. The direct effect of this will be further changes in tax legislation in Member States, including Ireland. The removal of discriminatory rules in other Member States may also have an indirect benefit for Irish business (e.g. if CFC rules were struck down).

No Irish tax cases have come before the ECJ to date. However, we have found non-discrimination arguments helpful in dealings with the Irish Revenue.

Role of the ECJ

Although direct taxation falls within the competence of Member States, they must none the less exercise that competence in accordance with Community Law. The ECJ ensures that Community law is interpreted and applied consistently in each Member State. It strikes down laws in breach of the fundamental freedoms laid down in the Treaty. The freedoms most relevant to direct tax are freedom of establishment, freedom to provide services and free movement of capital. The influence of the ECJ has grown to such an extent that it is attacking fundamental tenets of the corporate tax systems of various Member States.

Potential benefits for Irish companies?

Recent changes to Irish tax law have included direct responses to ECJ cases (e.g. *St. Gobain and ICI v Colmer cases*). Changes have also been made to deal with rules that were potentially vulnerable to challenge (e.g. the complete abolition of distribution treatment for interest paid to EU resident affiliates in Finance Act 2002).

The Irish tax system remains potentially in breach of EU law in a number of areas, including company migration toll charges and various deferral provisions.

The most significant issues ahead for Irish companies are discussed below.

Taxation of Foreign Dividends

An analysis of the case-law of the ECJ (e.g. the recent decision in the Manninen case) makes it clear that EU Member States' tax systems should not deter persons from investing in foreign shares. In an Irish context, the judgement throws into question whether the Irish system of corporate taxation on dividends is compatible with the EC Treaty as an Irish company does not pay Irish corporation on dividends received from an Irish company, but an Irish company is subject to tax on dividends received from foreign companies. While the changes to the foreign tax credit system introduced in Finance Act 2004 were welcome in themselves, it is clear that they do not go far enough to eliminate discrimination under Irish legislation.

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Conversely, dividends received by EU shareholders of an Irish company should not be subject to a greater level of taxation than dividends received from a company in their own jurisdiction. This may make it more attractive to invest in Ireland.

Cross border loss relief

The *Marks & Spencer* case dealing with cross border loss relief is due to come before the ECJ in mid-2005. If successful, the case will potentially have a revolutionary impact on multinational taxpayers operating through multiple entities or business units in the EU. Many European tax systems, including Ireland, will be in breach of the EC Treaty. Fundamental changes to loss relief or tax consolidation provisions will be required.

This may result in Irish companies being able to benefit from losses incurred by foreign affiliates and/or foreign affiliates being able to obtain relief for losses incurred by Irish companies.

Transfer Pricing

There have been developments in this area over the last number of years. Member States have responded by 'harmonising downwards', with the result that domestic companies have been put on the same footing as international companies and not the other way around. While Ireland does not have a formal transfer pricing regime, a definitive undertaking has been given that one will be introduced. Any such regime will have to apply in the domestic as well as the international sector.

Controlled Foreign Companies (CFC)

The clear objective of the EC Treaty is to facilitate the optimal allocation of economic resources within the Community. On the other hand, the explicit objective of all controlled foreign company ('CFC') legislation is to protect the domestic tax base from erosion, caused by the outflow of capital to low tax jurisdictions. On 6 June 2004, the *Cadbury Schweppes* case dealing with the United Kingdom's CFC legislation was referred to the ECJ.

The principal issue in the case is that the deemed taxation on the parent company of the profits of a subsidiary established in another EU Member State, as compared to the absence of such deemed taxation for a domestic subsidiary, is contrary to the freedom of establishment enshrined in the Treaty. There is a strong possibility that the ECJ will determine that the UK CFC legislation in its current form is incompatible with the fundamental freedoms in the Treaty. Such a judgement would have a significant impact on Member States with CFC legislation, and might impact favourably on EU investment in Ireland.

'Most favoured nation principle'

The Advocate General ('AG') recently gave an opinion in favour of the taxpayer in the case of *D v. Rijksbelastingdienst* which, if followed by the ECJ, is likely to lead to wider global tax implications. In general, the ECJ has tended to follow AG rulings.

The case concerned the availability of a Dutch wealth tax allowance to a non-national. The AG opined that any wealth tax law giving resident taxpayers a right to a rebate, which it denies to non-residents, is in breach of the free movement of capital provisions of the EC Treaty. Interestingly, the AG indicated that a national of one Member State should be able to claim the benefit of the best host state tax treaty if it is more favourable ('most favoured nation' treatment). If adopted by the ECJ, the principle will enable taxpayers (including Irish companies) to claim the benefit of the best tax treaty between EU Member States and any other EU or third country.

For example, this may allow an Irish company to receive interest without withholding tax even where the bilateral tax treaty with Ireland allows such tax to be levied.

Conclusion

ECJ decisions are remarkably consistent and two clear patterns have emerged from the case law to date. Firstly, the threshold which the taxpayer must meet when demonstrating that a law breaches a freedom is exceptionally low. Secondly, the threshold a national government must meet when justifying that law on grounds of public interest is exceptionally high.

The cases demonstrate that many Member States have tax provisions that are arguably incompatible with the EC treaty fundamental freedoms. It is likely that there will be increasing litigation in this area, with resultant changes to Member States' tax systems. Such changes may bring about opportunities, e.g. in the foreign taxation of transactions involving Ireland.

Occasionally an apparently inoffensive Irish rule may be found to have a discriminatory effect in a specific situation. Companies should be alive to the possibility of using non-discrimination arguments in their dealings with Revenue, and of making a protective claim when appropriate.

If you have any comments on the content of this publication, or have any other issues you would like to raise, please contact your usual tax contact within PricewaterhouseCoopers, or one of the following:

Enda Faughnan, +353 1 662 6359 — Partner, Banking, Treasury, Securitization, enda.faughnan@ie.pwc.com

Jim McDonnell, +353 1 662 6836 — Partner, Banking, Asset Finance, jim.mcdonnell@ie.pwc.com

Patrick Wall, +353 1 704 8602 — Partner, Insurance, Investment Management, patrick.wall@ie.pwc.com

Rory MacIver, +353 1 662 6658 — Director, Banking, Editor of IFS Newsalerts, rory.maciver@ie.pwc.com

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