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**Our Reference:** 3096/PGCI/003/

2 April 2019

Transfer Pricing Rules – Public Consultation
Tax Division
Department of Finance
Government Buildings
Upper Merrion Street
Dublin 2

BY EMAIL TO: tpreview@finance.gov.ie

**Re: Public Consultation – Transfer Pricing Rules**

Dear Sir/Madam,

## 1. INTRODUCTION

We welcome the opportunity to respond to the Department of Finance Public Consultation on Transfer Pricing Rules (the "**Consultation**"). As a policy matter, we consider it hugely beneficial that the Department engages in regular and detailed consultations, on a broad range of tax policy matters. Taking this proactive approach will ensure a more reflective principled approach to tax policy in Ireland. Given that the subject of the Consultation may result in significant legislative changes, we would encourage the Department to publish all draft tax legislation arising from the Consultation in full for technical consultation with interested stakeholders. To ensure the Consultation process is worthwhile, the Department should provide an appropriate period in which to consult with stakeholders on the draft legislation. This would better achieve the aims of the legislation in question and would avoid the need to make subsequent amendments to the law to deal with unanticipated consequences. Furthermore, engaging in such a process will ensure that Ireland maintains an open, transparent, stable and competitive corporate tax regime with best in class, fully considered legislation. This would not interfere with the parliamentary process as the Oireachtas can choose to enact, amend or reject any bill.

## 2. EXECUTIVE SUMMARY

Major changes to the Irish corporate tax system have already been implemented and will continue to be implemented over the coming years as a result of both EU and OECD tax policy measures. Since the rate of change over the last few years has been unprecedented, we are strongly of the view that a fundamental review of the structure and legislative basis of the Irish corporation tax system should be undertaken. To this end, as suggested in a number of previous public consultations, we would strongly advocate that the Department convene an expert group of tax lawyers, tax accountants and economists from different jurisdictions (including Ireland) to map out the future direction of the Irish corporate tax system post-ATAD and BEPS.

We have set out our initial views in relation to the reform of the Irish corporate tax system in paragraph 3 of this letter. In paragraphs 4 and 5, we have set out our responses to the specific questions raised by the Consultation.

Our comments on the reform of the Irish corporate tax system are specifically relevant to the Consultation as the proposed extension of transfer pricing rules to capital and non-trading transactions gives rise to a number of difficulties where an extension to transfer pricing rules is layered onto the existing corporate tax system.

## 3. REFORM OF THE IRISH CORPORATE TAX SYSTEM

The fundamental changes that are being introduced due to ATAD and BEPS requires Irish policy makers to step back and fundamentally reconsider the taxation of corporate entities. We have previously made a number of suggestions of the items that ought to be re-considered in this area (please see our responses to consultations on Hybrids and Interest Limitation Rules -January 2019 and Review of the Corporation Tax Code -January 2018). As noted above, we would strongly advocate that the Department convene an expert group of tax lawyers, tax accountants and economists from a number of different jurisdictions (including Ireland) to map out the future direction of the Irish corporate tax system post-ATAD and BEPS. Some suggestions on specific issues related to Transfer Pricing are set out below.

### 3.1 Simplifying the Taxation of Income

Unlike Ireland, most tax systems operate a single income concept and do not operate a schedular system of taxation (i.e. they do not artificially split commercial income into many different categories). Some systems do not distinguish between income and capital. Most systems operate a group consolidation system; Ireland's is only a partial and patchy group relief system. Most jurisdictions apply one rate of corporation tax on income (rather than potentially three: 12.5%, 25% and 45% (if the close company surcharge applies)). Some systems tax corporate gains at the same rate as income whereas Ireland taxes corporate gains at a higher rate. Bearing in mind the application of the close company rules, it may be the case that very little tax revenue would be lost by reducing the 25% rate to 12.5%. This is because, in our experience, very little tax is paid at the 25% rate. It is also noteworthy that our two largest trading partners (the UK and the US) will now have rates of corporation tax at our substantially less than the 25% rate. This means that Ireland's tax policy of having a rate of tax that is lower than its competitor jurisdictions is not being complied with for so long as the 25% rate of corporation tax is retained. Similarly, the corporate capital gains tax rate in the UK and the US is significantly lower than the Irish rate. These challenges make wide-ranging Irish transfer pricing rules far more administratively complex than in other jurisdictions. This will undermine the well deserved credit given to Ireland's policy makers for developing an efficient tax collection system with streamlined filing requirements.

By aligning the corporation tax rates at 12.5% for all types of income and gains, the need for internal Irish transfer pricing rules disappears. It would also significantly reduce the administrative burden imposed upon Irish businesses that operate within Ireland.

If it is desired to retain our current corporation tax rate structure (and we would advocate a single low rate for all income and gains) there should be only two "buckets of income": passive income and active income. Active income could continue to be taxed at the 12.5% tax rate and passive income at the 25% tax rate. Corporate gains should follow this rate structure such that assets used in a trade should be taxed at 12.5% and gains on other assets should be taxed at 25%.

### 3.2 Simplifying Expense/Cost Deduction

The rules for deductibility of expenses associated with the different “Cases” of Schedule D differ and the ability to offset losses arising in one “Case” against income of another “Case” is inconsistent and overly restrictive. Instead, losses and expenses should be fully available against all categories of income. If the current two rate structure of corporation tax is to be retained, loss utilisation can be on a value basis, i.e. if passive expenses/losses are utilised against active income they are done at a rate proportionate to the tax rate differential and vice versa. Since companies are engaged in earning money for their shareholders and other stakeholders (this is their fundamental objective) then all expenses incurred for that business should in principle be deductible on an accruals basis against all taxable profits or, if a two rate structure is retained, against the “bucket” of income to which it relates. The “charge on income concept” and Section 247 of the TCA should be abolished in its entirety and interest on, or costs associated with, any debt incurred for the purposes of earning taxable income should be deductible as it accrues in the statutory accounts, subject to anti-avoidance and other rules. One could introduce a wholly and exclusively concept (similar to Section 81 of the TCA) for all expenses so that the deductibility test is applied as is currently the case for trading expenses. A better approach would be a “to the extent” approach, i.e. expenses should be deductible “to the extent” that they are incurred for the purpose of earning taxable profit. Effectively, specific rules for deductibility of expenses for each “Case” would be abolished and deductibility rules would be aligned with the general deductibility rules.

If a cost or expense is non-deductible in a corporate payer, the receipt should be tax exempt in a recipient otherwise tax symmetry is not achieved. Transfer pricing rules should ensure this is the outcome achieved by converting any non-deductible expense into a “distribution”. There should be no DWT as there would be a refund due in any event in the vast majority of cases.

### 3.3 Simplifying the Taxation of Corporate Groups

The current group relief rules are overly complex and unsuited to modern group structures. Most jurisdictions operate corporate consolidation systems i.e. the US consolidated group concept, the German organschaft concept etc. Ireland should introduce a consolidation system similar to one of these examples. This would simplify administration (like an Irish VAT group) and prevent temporal mismatches arising within corporate groups. For example, currently a loss in Company A can become “stranded” if group Company B has profits but not in the same year as the loss arose in Company A. It would be utilisable if it arose in a single company. As a result the corporate group makes an economic loss but can make at taxable profit. This could be achieved in a simple manner by altering the application of the existing group relief rules so that, instead of being able to surrender losses, the companies could elect to be consolidated. Other consolidation systems could be examined to ensure that opportunities for avoidance are eliminated.

This would eliminate the administrative impacts of transfer pricing for corporate groups (as it does for VAT groups) without any loss of taxation.

## 4. SPECIFIC QUESTIONS RAISE IN THE CONSULTATION

### 4.1 Incorporation of the OECD 2017 Guidelines into Irish legislation

*It is intended that Irish transfer pricing legislation will be amended to include a direct reference to the 2017 OECD Transfer Pricing Guidelines. Do you consider that this proposed course of action will give rise to any specific issues?*

Due to the effect of 2017 OECD Transfer Pricing Guidelines in particular as they relate to intangibles we expect that the application of these rules will give rise to an increase in transfer pricing disputes requiring input from competent authorities.

In order to ensure that cases are resolved effectively it will be important that Revenue has a strong, well-resourced Competent Authority team. We appreciate that the Irish Competent Authority team has expanded in recent years, but we still have a concern about the capacity of the team to deal with the likely increase in cases in a timely and efficient manner.

### 4.2 Removal of the exemption for arrangements in place since pre July 2010

*It is intended to extend the transfer pricing legislation to arrangements the terms of which were agreed before 1 July 2010, commencing from 1 January 2020. Do you consider that this proposed course of action will give rise to any specific issues?*

In our view transfer pricing legislation should not be extended to those transactions which continue to benefit from the 2010 grandfathering arrangements. For businesses already dealing with a myriad of tax changes including those arising due to ATAD and BEPS this will be a further administrative burden.

In any event, given the passage of time and likely changes to arrangements entered into since 1 July 2010, many arrangements grandfathered in 2010 are likely to have terminated in the interim and remaining transactions are likely to unwind over time. Therefore, in our view, the 2010 grandfathering should be retained to allow those transactions run their course with any new transactions covered by the transfer pricing rules.

### 4.3 Extension of transfer pricing rules to SMEs

*Do you consider that transfer pricing legislation should be extended to small and medium enterprises? What level of documentation do you feel would be appropriate to require SMEs to maintain to demonstrate compliance with transfer pricing rules? If transfer pricing rules are extended to SMEs, what other measures might be considered to mitigate the compliance burden for SMEs? What particular issues do you consider might arise from the application of transfer pricing rules to SME transactions with effect from 1 January 2020?*

There is a large number of existing market value/fair value rules applicable in the absence of the expansion of the transfer pricing rules to SMEs. A list of these rules are contained in Appendix 1 and it is submitted that these rules address the need for full transfer pricing rules in the circumstances to which they apply. Accordingly, transfer pricing rules should not apply in those circumstances. If transfer pricing rules are applied to those circumstances, the relevant provision shod be removed to eliminate duplication.

The introduction of transfer pricing for SMEs will provide particular challenges to a business operating in Ireland that may not exist in other jurisdictions. Due to the small size and international focus of the Irish economy, a disproportionate number of small businesses transact cross border. In fact, the growth path of any small Irish business will often include a cross- border element at an earlier stage than in other jurisdictions. Accordingly, we believe that the transfer pricing rules should not be extended to SMEs, as it would impose an administrate burden that is disproportionate to the tax objectives to be obtained, bearing in mind the low level of Irish tax at stake, particularly as the countries with which they predominately trade (UK, other EU and the US) have higher tax rates than the 12.5% rate. Most SMEs remove the bulk of their revenue to the founders by way of salary payments (which are taxed at the founder/director level at very high marginal rates for individuals, i.e. in excess of 50% and also are subject to the close company rules). These rules effectively mandate the distribution of profits to avoid a 20% surcharge with the effect that profits are distributed and taxed at the very high marginal tax rates applicable to individuals. Accordingly, there would seem to be little scope for tax avoidance due to transfer pricing among SMEs.

To the extent that it is decided to extend the transfer pricing to SMEs reduced documentation requirements should apply.

### 4.4 Extending Transfer Pricing Rules to non-Trading Income and Capital Transactions

*It is intended to extend the transfer pricing rules to non-trading income chargeable to tax under Case III, Case IV and Case V of Schedule D where such an extension would reduce the risk of aggressive tax planning as recommended by the Coffey Review. Are there are issues which may arise through the extension of transfer pricing rules to non-trading income and how may any such issues be resolved? Do you believe that the current market value rules are sufficient so that capital transactions do not need to be subject to separate transfer pricing rules? Could these rules be supplemented by additional documentation requirements?*

The fundamental administrative problem with introducing a full set of transfer pricing rules to non-trading and capital transactions is the high administrative burden that the OECD has adopted in relation to document creation and retention. Even where a transaction occurs at arm's length between connected parties and in some cases where a higher tax burden arises because the pricing is greater than arm's length, a tax payer can still be in default in the absence of appropriate documentation. This is clearly a poor administrative outcome. Whilst a large multinational business is able to bear the cost of those documentary requirements (in addition to the substantive point of ensuring that the price is the appropriate price) those rules would seem to add an unnecessary additional burden to transactions within Ireland. As mentioned above, the prospect of businesses that properly price transactions having to pay penalties as a result of not complying with this onerous documentary requirement would seem to be an excessive use of government power. In addition the concern around aggressive tax planning is no longer a valid concern due to tax changes arising from other aspects of BEPS and ATAD.

There appears to be no need to extend transfer pricing rules to capital transactions as they are subject to extensive arm's length rules already. As noted above a list of existing market value/fair value rules applicable in the absence of the expansion of the transfer pricing rules are contained in Appendix 1. It seems unnecessary to impose an administrative burden of transfer pricing rules where the avoidance is already addressed by existing rules. This is supported by comments in the Coffey Report[1] as follows:

*"Given the already existing provisions to impose equivalents to the arm's length value to the chargeable gains of companies, capital allowances or balancing charges in respect of related party transactions, any extension of transfer pricing rules in this area should be commensurate to the risk of mispricing occurring."*

In our view any extension of transfer pricing rules should apply only to transactions not already covered by an arms-length or open market value provision.

We have specific concerns with respect to the extension of transfer pricing rules to non-trading loan transactions in the absence of reform of our tax system. The following is an extract from the Coffey Report[2] in relation to this point

*"Any change in this area may impact on bona fide intra-group financing, such as intra-group treasury operations. Groups may use cash pools to manage the liquidity requirements of the group by using the surplus cash available to some group affiliates to fund the cash requirements of other group affiliates through intra-company loans. This allows groups to avoid recourse to external credit markets and associated costs. Depending on the facts and circumstances of existing intra-group cash pooling structures, the group company designated as the 'cash-pool leader' may not be considered as engaging in a trade when engaging in intra-company lending associated with cash pooling. As a consequence, where the cash-pool leader extends a loan to another affiliate, the interest associated with the loan may be chargeable to tax at 25% in respect of non-trading income but the other group affiliate will only receive a deduction at 12.5%."*

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[1] Paragraph 6.4.8 of the Review of Ireland's Corporation Tax Code by Seamus Coffey

[2] Paragraph 6.4.4 of the Review of Ireland's Corporation Tax Code by Seamus Coffey

In the scenario outlined it is envisaged that a deduction at 12.5% will be available. However, due to the complex rules relating to deductibility of interest, in many cases, no deduction would be available. In addition as identified in paragraph 3 above Ireland does not have a consolidated group system which would avoid artificial tax liabilities arising due to transfer pricing on transactions within domestic groups. Due to these issues we are not in favour of an extension of the transfer pricing rules to capital and non-trading transactions in the absence of reform of the Irish corporation tax system.

The profits of qualifying companies under Section 110 Taxes Consolidation Act1997 are taxed under Case III and in some cases may be in the scope of transfer pricing rules if they extended to Case III transactions. Section 110 already contains a "bargain made at arm's length" requirement (other than in respect of profit participating loan notes which are subject to specific anti-avoidance rules) and therefore it unnecessary to impose the additional administrative burden of transfer pricing rules.

If the transfer pricing rules are to be extended to capital and non-trading transactions they should apply only to transactions not already covered by an arms-length or open market value provision. To the extent that the rules are extended we consider it appropriate that the rules should apply in respect of new transactions only with existing arrangements grandfathered. As mentioned above, businesses are already dealing with the administrative burden of restructuring due to significant tax changes including those arising due to ATAD and BEPS. In the absence of grandfathering arrangements, companies may have a significant administrative burden in reviewing all existing arrangements in a short timeframe.

### 4.5 Extending Transfer Pricing Documentation

*What particular issues do you consider might arise if the enhanced documentation requirements were to apply from 1 January 2020? Are there any circumstances in which the documentation requirements should be reduced or limited in specific respects?*

Our understanding of this question is that it relates specifically to the Master File and Local File requirements outlined in Annex I and II or Chapter V of the OECD 2017 Transfer Pricing Guidelines. We have concerns in relation to the additional administrative burden of these enhanced documentation requirements and based on these concerns we would propose firstly, to the extent that transfer pricing rules are extended to SMEs, there should be an exemption from the requirement to prepare master files and local files for SMEs. Secondly, the requirement to prepare a local file should be simplified so that a country file is required for Ireland rather than a specific local file for each entity. Thirdly, there should be no requirement to file the Master File and Local file with Revenue but instead the documentation should be provided to Revenue on request.

### 4.6 Application of the Authorised OECD Approach to branch profit attribution.

*Do you consider that the Authorised OECD Approach to attribution of branch profits would be an appropriate approach to adopt into Irish law? If the Authorised OECD Approach is adopted in Irish law, what documentation requirements should apply? Is there an alternative approach that should be considered in this context? Are there any industry or sector-specific considerations that should be borne in mind, particularly in relation to financial and insurance companies, in relation to branch profit attribution? Are there any special considerations required in respect of SMEs?*

We have no comments on this question.

Thank you for taking the time to consider our views.

Yours faithfully

Arthur Cox

ARTHUR COX

## APPENDIX 1

## TRANSFER PRICING RULES

| **Arm's Length** |
|---|
| 89. Valuation of trading stock at discontinuance of trade. |
| 98A. Taxation of reverse premiums. |
| 110. Securitisation. |
| 234. Certain income derived from patent royalties. |
| 249. Rules relating to recovery of capital and replacement loans. |
| 275. Restriction of balancing allowances on sale of industrial building or structure. |
| 95. Supplementary provisions as to tax under section 91 or 94. |
| 323. Capital allowances in relation to construction of certain commercial premises. |
| 324. Double rent allowance in respect of rent paid for certain business premises. |
| 332. Capital allowances in relation to construction or refurbishment of certain commercial premises. |
| 333. Double rent allowance in respect of rent paid for certain business premises. |
| 342. Capital allowances in relation to construction or refurbishment of certain commercial premises. |
| 345. Double rent allowance in respect of rent paid for certain business premises. |
| 354. Double rent allowance in respect of rent paid for certain business premises. |
| 372N.Capital allowances in relation to construction or refurbishment of certain commercial buildings or structures. |
| 372W. Capital allowances in relation to construction or refurbishment of certain commercial premises. |
| 372D. Capital allowances in relation to construction or refurbishment of certain commercial premises. |
| 372AAC. Capital allowances in relation to conversion or refurbishment of certain commercial premises. |
| 372AAD. Residential accommodation: capital allowances to lessors in respect of eligible expenditure incurred on the conversion and refurbishment of relevant houses |
| 486B. Relief for investment in renewable energy generation. |
| 512. Disposals of scheme shares. |
| 547. Disposals and acquisitions treated as made at market value. |
| 549. Transactions between connected persons. |
| 589. Shares in close company transferring assets at undervalue. |
| 611. Disposals to State, public bodies and charities. |
| 690. Interest and charges on income. |
| 696. Valuation of petroleum in certain circumstances. |
| 697LA. Transactions between associated persons and between tonnage tax trade and other activities of same company. |
| 766. Tax credit for research and development expenditure. |
| Schedule 14 Capital Gains Tax: Leases |
| **Market Value** |

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| 29A. Temporary non-residents. |
| 55. Taxation of strips of securities. |
| 81A. Restriction of deductions for employee benefit contributions. |
| 110. Securitisation. |
| 122A. Notional loans relating to shares, etc. |
| 130. Matters to be treated as distributions. |
| 137. Disallowance of reliefs in respect of bonus issues. |
| 249. Rules relating to recovery of capital and replacement loans. |
| 324. Double rent allowance in respect of rent paid for certain business premises. |
| 333. Double rent allowance in respect of rent paid for certain business premises. |
| 345. Double rent allowance in respect of rent paid for certain business premises. |
| 354. Double rent allowance in respect of rent paid for certain business premises. |
| 372AAC. Capital allowances in relation to conversion or refurbishment of certain commercial premises. |
| 496. Disposals of shares. |
| 512. Disposals of scheme shares. |
| 541A. Treatment of debts on a change in currency. |
| 543. Transfers of value derived from assets. |
| 547. Disposals and acquisitions treated as made at market value. |
| 549. Transactions between connected persons. |
| 559. Assets derived from other assets. |
| 589. Shares in close company transferring assets at undervalue. |
| 596. Appropriations to and from stock in trade. |
| 604A. Relief for certain disposals of land or buildings. |
| 607. Government and certain other securities. |
| 613A. Supplementary provisions. |
| 615. Company reconstruction or amalgamation: transfer of assets. |
| 620A. Deemed disposal in certain circumstances. |
| 621. Depreciatory transactions in group. |
| 625. Shares in subsidiary member of group. |
| 627. Deemed disposal of assets. |
| 641. Computation under Case I of Schedule D of profits or gains from dealing in or developing land. |
| 642. Transfers of interests in land between certain associated persons. |
| 649B. Windfall gains from rezonings: rate of charge. |
| 651. Restriction of indexation relief in relation to relevant disposals. |
| 696. Valuation of petroleum in certain circumstances. |
| 705P. Effect of cessation. |
| 724. Transfer of assets into or out of special investment fund. |
| 737. Special investment schemes. |
| 738. Undertaking for collective investments. |
| 739. Taxation of unit holders in undertakings for collective investment. |
| 741. Disposals of material interests in non-qualifying offshore funds. |
| 747E. Disposal of an interest in offshore funds. |
| 848J. Gain on maturity. |
| 848K. Gain on cessation. |
| 848L. Gain on withdrawal. |
| Schedule 12C Approved Share Option Schemes |
| Schedule 16 Building Societies: Change of Status |

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| Schedule 18A Restriction on set-off of pre-entry losses |
| Schedule 18B, Part 3 Capital Allowances, Balancing Charges and Related Matters (paras. 10-20) |
| Schedule 25A Exemption from Tax in the Case of Gains on Certain Disposals of Shares |
| **Open Market** |
| 89. Valuation of trading stock at discontinuance of trade. |
| 275. Restriction of balancing allowances on sale of industrial building or structure. |
| 286A. Wear and tear allowances for licences for public hire vehicles. |
| 289. Calculation of balancing allowances and balancing charges in certain cases. |
| 312. Special provisions as to certain sales. |
| 324. Double rent allowance in respect of rent paid for certain business premises. |
| 333. Double rent allowance in respect of rent paid for certain business premises. |
| 400. Company reconstructions without change of ownership. |
| 669I. Provisions as to deductions. |
| Schedule 18B, Part 3 Capital Allowances, Balancing Charges and Related Matters (paras. 10-20) |