Ireland: A gateway to China and Japan

Ireland has become a jurisdiction of choice for making equity investments in China and Japan, say David Lawless and Sean Murray of Dillon Eustace

Ireland's favourable tax treaties with China and Japan, regarding capital gains, mean that it is increasingly seen as a jurisdiction of choice for making equity investments in those countries. While there are a number of tax efficient Irish structures available for making such investments, we have concentrated solely for the purposes of this article on Ireland's holding company regime.

In 2004, Ireland received EU approval for its holding company regime. This was seen as a significant step in transforming Ireland's appeal as a holding company location, as together with Ireland's favourable domestic tax law provisions and ever-increasing double-tax treaties, Ireland had now introduced a capital gains tax participation exemption for disposals of qualifying shareholdings, and amended the taxation treatment applicable to repatriated foreign dividends received by Irish resident companies.

Four years and four Finance Acts later, the indications are unquestionably positive and Ireland has certainly begun to climb up the rankings as a favourable holding company jurisdiction.

Taxation of Irish holding companies

Capital gains exemption on investment

The legislation provides that the disposal of shares in a subsidiary company by an Irish company will be exempt from capital gains tax provided the following conditions are met:

- The Irish company must have held at least 5% of the ordinary share capital (including the rights to profits and assets on a winding up) for a continuous 12-month period and the disposal must take place during or within two years after the date of meeting the aforementioned holding requirement;
- The shares being disposed of must be in a company resident in the EU (including Ireland) or in countries with which Ireland has concluded a double tax treaty;
- At the time of disposal:
  - the shares being disposed of must be in a company whose business consists wholly or mainly of the carrying on of a trade or trades, or
  - taken together the business of the holding company and that of the companies in which it has a direct or indirect 5% or more holding, consist "wholly or mainly" (see below) of the carrying on of one or more trades.
- The exemption may also apply to a disposal of assets related to shares (that is, options, convertible debt) but the shares must not derive the greater part of their value (that is, more than 50%) in land, buildings or mineral rights in Ireland.

The Irish tax authorities have issued guidance in relation to the aforementioned "wholly or mainly" test (Tax Briefing 66 – issued July 2007). The guidance confirms that "wholly or mainly" means greater than 50% and that the primary tests to determine whether a company or group is wholly or mainly trading are the proportion of net trading profits and the proportion of net trading assets, though other factors may be taken into account. These lesser considerations would include trading turnover as a proportion of gross receipts and the proportion of employees' time devoted to trading and non-trading activities.

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In determining if the exemption conditions are met, it should be noted that:

- The company does not need to hold onto its entire shareholding for the relevant 12-month period; the exemption will apply provided the holding company holds 5% of the shares for that 12-month period. Consequently, even if it has not met that 12-month test prior to disposing of up to 95% of the shareholding, that disposal will still be exempt provided that at least 5% is held for greater than 12 months; that is, the disposal will still be exempt once the 5% holding reaches its first anniversary.
- Furthermore, the company is not required to dispose of its entire shareholding to obtain the participation exemption; once the prescribed holding requirements as outlined above are met, the gain arising on any piecemeal disposal will be exempt.
- In the case of stocklending and repo transactions, for the purposes of determining the holding period, the period during which the shares have been temporarily lent or sold will be regarded as a period of ownership of the original holder.

Payment of dividends from Ireland – dividend withholding tax exemptions

Ireland imposes a 20% withholding tax on dividends and other profit distributions. However, there are significant exemptions under domestic law from this withholding tax in relation to payments made to companies' resident in EU member states and tax treaty countries and payments made to companies resident outside the EU or a non-tax treaty country provided more than 50% of the company is ultimately controlled by persons resident in a treaty country or EU member state (other than Ireland).

So for example, dividends may be made free of Irish dividend withholding tax to a Cayman resident company provided that the Cayman company is ultimately more than 50% controlled by persons resident in a country with whom Ireland had a double tax treaty in force or are resident in an EU member state (other than Ireland).

Taxation of domestic and foreign dividends received

Dividends and other profit distributions received by an Irish resident company from another Irish resident company are exempt from tax.

Foreign dividends are taxed at either 12.5% or 25%. The 12.5% rate will apply where the dividends are paid from EU or tax treaty countries out of trading profits (other than certain development and exploration profits). In all other cases the 25% rate will apply subject to the following two instances:

- The full amount of a foreign dividend received will be treated as paid from trading profits and therefore chargeable at the 12.5% where:
  - At least 75% of the distributing company's profits are trading profits, or are dividends received out of trading profits of subsidiary companies that are resident in EU or tax treaty countries; and
  - The aggregate value of the trading assets of the recipient company and all its 5% subsidiaries must not be less than 75% of the aggregate value of all the assets held by such companies;

  Or
- Portfolio dividends (holdings of 5% or less) from an EU or double tax treaty resident company will be taxed at 12.5% regardless of the source of the profits.

Nevertheless, the availability of foreign tax credits (for withholding taxes and underlying tax borne by the foreign company paying the dividend), together with tax credit "pooling", should ensure that with appropriate planning little or no Irish tax should arise on foreign dividends for the most part.

Finance Act 2004 introduced a form of onshore pooling, so that when foreign dividends have suffered foreign tax in excess of the Irish rate, excess foreign tax credits in respect of these dividends may be offset against Irish tax on dividends that have suffered foreign tax at a rate lower than the Irish rate – that is, excess foreign tax credits can be pooled. Finance Act 2008 amended these rules for the blended rates of taxation on foreign dividends.

Foreign taxes on dividends are relieved in three ways:

Bilateral credit relief: Under Ireland's double tax treaties, double tax relief is provided with regard to withholding taxes suffered on income received and, in the case of foreign dividends, there is also relief for taxes from which the dividends are paid (that is, underlying taxes) though this will typically require certain minimum levels of voting power.

EU Parent-Subsidiary Directive: Ireland is one of many countries that have adopted the above directive. Essentially under this directive, when a company resident in Ireland receives a dividend from a country in another EU member state, underlying tax relief is available in respect of the foreign tax borne by either (i) the foreign company or (ii) by lower tier shareholdings, provided there is a 5% holding at each tier. There is no minimum ownership period under the domestic provisions implementing the directive.

Unilateral credit relief: This provides for a credit relief where a minimum holding of 5% is required. This relief applies in the case of treaty and non-treaty countries and facilitates tax credits in respect of tax borne at first and subsequent tiers of ownership. Any foreign tax that does not qualify for relief by credit may be claimed as a deduction. Furthermore, a system of tax credit pooling is now also available, whereby excess foreign tax credits on one source of foreign dividend can be offset against the corporate tax arising on another source of foreign dividend.

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He has advised on all aspects of financial services (including VAT and stamp duty) – structured finance transactions, investment management, capital markets, real estate, private equity, banking, treasury and reinsurance.

He has written and spoken extensively on these topics and has participated in many public-private tax committees in Ireland to make Ireland an attractive tax location.

He is a member of the tax committees of the Irish Funds Industry Association (IFIA), the Alternative Investment Management Association (AIMA), the Irish Securitization Forum and the Law Society of Ireland.

Other considerations

- *Capital duty* – There is no capital duty on the issue of shares.
- *Stamp duty* – Stamp duty at a rate of 1% may arise on the transfer of shares in Irish companies, based on market value. However there are various reliefs, exemptions and tax planning mechanisms for avoiding or minimising any stamp duty payable.
- *Capital gains tax* - Irish capital gains tax will only arise on disposition of shares by a non-Irish resident shareholder in an Irish resident company where the shares in question derive the greater part of their value from Irish immovable property or Irish situated minerals or mining rights.
- *VAT* - If a company's activity is limited to the holding of shares, then the company should not be regarded as a taxable person for VAT purposes. Consequently, the company will not be entitled to deduct VAT input credits (although likewise the company should not have to self-account for Irish VAT

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on the receipt of any services received from non-Irish suppliers). However if the company is involved in activities other than the holding of shares (for example, provision of management services) then it will be possible to deduct all input VAT costs (and consequently recover any Irish VAT suffered) if solely holding and managing non-EU assets (such as shares in a Japanese and/or Chinese company).

- *CFC and thin capitalisation* – Ireland's tax legislation does not contain any controlled foreign corporation (CFC) legislation, nor does it have any thin capitalisation rules.
- *Deduction of costs* - Generally the expenses of management are deductible against a holding companies taxable profit. Furthermore, a company will generally obtain (on a paid basis) a deduction for interest on loans relating to the acquisition of shareholdings subject to certain restrictions.

The Asian connection

China

Under the China-Ireland Double Tax Treaty, China should not tax capital gains derived from a transfer of shares in a Chinese company (regardless of the percentage size of the shareholding – many of China's tax treaties have a 25% shareholding restriction to benefit from the Chinese capital gains tax exemption) if the company is not directly or indirectly principally comprised of immovable property in China.

Furthermore withholding tax on dividends is reduced from 10% to 5% if the Irish company holds directly at least 25% of the voting power of the Chinese company. In all other cases Chinese dividend withholding tax will be 10%.

Japan

Japanese Domestic law provisions: As a general rule, capital gains arising from the sale of Japanese shares are not taxed.

Notwithstanding the above, capital gains are taxable in the following circumstances:

- If capital gains arising from transactions where a foreign company has purchased a large number of shares in the Japanese corporation and sells such shares to the Japanese corporation or a related entity (for example, majority holder) (Collective Sale Exception).
- If the seller and its affiliates hold 25% or more of the shares in a Japanese corporation, capital gains arising from the sale of 5% or more of the shares of that Japanese corporation are subject to tax, as a transaction similar to the sale of a business (Business Sale Analogy Exception).
- If the value of the real estate of the Japanese corporation in Japan is worth more than 50% of the total assets of the Japanese corporation, capital gains arising from the sale of such shares are subject to tax, as a transaction similar to the sale of real estate (Real Estate Sale Analogy Exception).
- If the business purpose of the Japanese corporation is the ownership of a golf course, and if owning shares in the Japanese corporation includes the benefit of membership at the golf course, capital gains arising from the sale of such shares are subject to tax, as a transaction similar to the sale of golf membership (Golf Membership Sale Analogy Exception).

Ireland-Japan Double Tax Treaty

The Japan-Ireland Double Tax Treaty stipulates that, except in respect of alienation of immovable properties and properties related to a permanent establishment in Japan, the capital gains arising from the alienation of property are not subject to Japanese taxation (Paragraph 2, Article 14).

In comparison with other tax treaties which clearly adopt the Real Estate Sale Analogy Exception and the Business Sale Analogy Exception from domestic law, we understand that this provision of the Japan-Ireland Tax Treaty should be interpreted as overriding the Collective Sale Exception, the Business Sale Analogy Exception, the Real Estate Sale Analogy Exception and the Golf Membership Sale Analogy Exception.

As a result of this provision, Japanese corporate tax, in the case of the Collective Sale Exception, the Business Sale Analogy Exception, the Real Estate Sale Analogy Exception and the Golf Membership Sale Analogy Exception, should not apply to capital gains received by an Irish resident entity.

Under the Ireland-Japan Double Tax Treaty for shareholdings of 25% or more, the rate of Japanese withholding tax on dividends is 10% and in all other cases the rate of dividend withholding tax is 15%.

Many benefits

Ireland's improving holding company regime will continue to ensure that it is considered as a jurisdiction for locating a holding company, in particular where Ireland's tax treaty network offers an advantage over some of the more traditional holding company locations.

In addition, Ireland offers other non-tax advantages, providing a more flexible labour market (for those who wish to establish an office in Ireland) and being English speaking.

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