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Study on Effects of Tax Systems on the Retention of Earnings and the Increase of Own Equity

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- ANNEX 11 -
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INTRODUCTION

On first appearances, one would imagine that Irish SMEs would retain substantial earnings each year given the very low rate (12.5%) of corporation tax applicable to those earnings.

However many SMEs take the position of paying as little corporation tax as possible believing that such tax is in effect wasted as further tax has to be paid to get any income into the owner's hands. No credit for corporation tax is given to the owners on distributions from profits that have already been taxed at the corporate level i.e. the profits are doubly taxed.

Notwithstanding the above, there are a number of measures in the Irish tax system that encourage the retention of earnings.

EXECUTIVE SUMMARY

There is a substantial differential in the tax rate applicable to income and capital gains. Individuals can be taxed at a combined rate of up to 46%[1] on income whereas the rate on capital gains is 20%. The following tax measures provide an incentive for owners of SMEs to accumulate rather than distribute profits:

- Trading income taxed at 12.5%[2]

- The rate of tax on the sale of shares of an SME including buy-backs and liquidations is 20%. Combined with the corporation tax rate of 12.5%, this equates to a composite rate of 30%, which compares favourably with a marginal income tax and social security cost of up to 46% (Incidentally stamp duty is avoided on liquidations).

- Retirement Relief [3] of up to €750,000 (€1,500,000 in the case of a husband and wife) is available. These amounts can be received free of any tax where the shares in the SME are sold on retirement.

- Unrestricted retirement relief for capital gains tax purposes is available on transferring shares in an SME to a child[4].

Owners of SMEs who take a shorter-term view or who see their company mainly as a vehicle for providing for their separate pension and do not necessarily want to keep all their eggs in one basket can use the very generous rules that allow full deduction for pension payments. Through a combination of salary and pension payments they can effectively eliminate the corporate tax liability and withdraw funds tax efficiently out of the company into a pension scheme independent of the company over which they can exercise investment control.

Given the availability of relatively cheap finance, and because interest charges are fully deductible in the company, borrowing is also an attractive form of finance for an SME. Full relief for interest on loans provided to the SME is also available to the owner in calculating his or her income tax liability.

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[1] 2007 – Top rate of income tax is 41% plus PRSI and Health Contribution of 5%
[2] Section 21 of Taxes Consolidation Act 1997
[3] Section 598 of Taxes Consolidation Act 1997
[4] Section 599 of Taxes Consolidation Act 1997

There is a disincentive for SMEs to retain passive and service income when the SME is a close company. Certainly in the case of the service income, this is an anomaly that should be eliminated.

Retained earnings of companies that carry out certain professional service type activities are subjected to an additional tax charge of 15% where they are left undistributed within 18 months of the end of the accounting period in which they have been earned. (Section 441 of the Taxes Consolidation Act 1997)

PART 1 – GENERAL QUESTIONS

1. **What are the main characteristics of the tax systems applicable on enterprises and business owners in your Country (corporate income tax, income tax, capital gains tax, other profit based taxes, capital based taxes, other taxes)?**

Ireland operates a self-assessment system for companies in relation to their corporation tax obligations. This means that each company is responsible for calculating their corporation tax liability and preparing and submitting their corporation tax return to the Irish Revenue. Each company must pay preliminary corporation tax the month before the end of their accounting period with the balance of their liability due 9 months and 21 days after the end of their accounting period which is also the due date for submission of their corporation tax return to the Irish Revenue. Each company resident in Ireland is liable to Irish corporation tax on all its profits wherever arising.

Groups of companies can also avail of loss relief known as group relief[5]. Under Irish legislation two companies shall be deemed to be members of a group of companies if one company is the 75% subsidiary of the other company or both companies are 75% subsidiaries of a third company. This means that trading losses may be surrendered by a company, which is a member of a group to another member of the same group, and that company may use that claim as a relief from corporation tax.

The standard rate of corporation tax on trading income has been 12.5% since the tax year ended 31 December 2003 while the higher rate, which is 25%[6] applies to certain excepted operations such as dealing in development land, working minerals and petroleum activities. The rates of capital allowances available on fixed assets from 4 December 2002 to the present tax year are as follows:

[5] Section 411 of Taxes Consolidation Act 1997
[6] Section 21A of Taxes Consolidation Act 1997

Type of Asset	Rate of Wear & Tear Allowances
Plant and Machinery	12.5%
Industrial Buildings	4%
Hotels	4%
Farm Buildings	15%

Section 766 of the Taxes Consolidation Act 1997 as expanded by Section 33 of the Finance Act 2004 introduced a tax credit for Research and Development expenditure by companies. This incentive consists of a credit of 20% of the incremental expenditure on revenue items, royalties, plant and machinery related to R&D, which can be offset against a company's corporation tax liability in the year in which it is incurred.

There is also a credit of 20% of the cost of a building used for the purposes of R&D and in respect of which capital allowances are granted which is available on a straight-line basis over 4 years.

The standard rate of Income Tax has been 20% since 2001 while the top rate decreased from 42% to 41% in 2007 following 6 years at 42%. For a single person, the standard rate applies to the first €35,400 earned in the 2008 tax year while any income above €35,400 is taxed at the top rate. For a married couple with dual incomes, the standard rate applies to the first €70,800 earned with any balance of income taxable at the top rate of 41%.

The normal rate of Capital Gains Tax has been 20% since 1999. There is an annual personal exemption of €1,270[7] available to each individual.

1.1. **Corporate**

1.1.1 What are the general principles for the computation of taxable profits?

Corporation tax is charged on the worldwide profits of Irish resident companies. Profits incorporate income from all sources and chargeable gains.

[7] Section 601 of Taxes Consolidation Act 1997

Corporation tax is not charged on dividends received from Irish resident companies. A company's income is computed under income tax rules and the amount of chargeable gains is computed under capital gains tax rules.

Special corporation tax rules apply to close companies. A close company is one, which is controlled by five or fewer persons or which is under the control of directors. Most Irish companies are close companies. Close companies[8] are subject to additional tax measures that are not applicable to other companies. A close company making a loan to a participator or an associate of a participator is obliged to pay over the tax equivalent to the standard tax rate (currently 20%) on the grossed up amount of the loan. This tax is repaid when the loan is paid back. Close companies must pay a 20% surcharge[9] on investment and rental income that is not distributed within eighteen months of the end of the accounting period in which the investment and rental income is earned. Additionally close companies that carry on professional services activities must pay a 20% surcharge on undistributed rental and investment income and a 15%[10] surcharge on half of their undistributed professional services income.

1.1.2 What are the main differences between the tax balance sheet and commercial balance sheet?

Only one balance sheet is prepared and this is the balance sheet as provided under company law.

1.1.3 What are the most important adjustments for the computation of taxable profits/taxable gains on the base of accounting profits?

[8] Definition of a close company in Section 430 of Taxes Consolidation Act 1997
[9] Section 440 of Taxes Consolidation Act 1997
[10] Section 441 of Taxes Consolidation Act 1997

i. Depreciation of fixed assets and intangibles for tax and accounting purposes.
ii. Entertainment expenses are not allowed for tax purposes.
iii. General provisions are not allowed for tax purposes.

1.2. Income

1.2.1. What are the general principles of income taxation of business owners on business income, wages, distributed earnings, interest on loans and capital gain (sale of shares)?

A business owner pays income tax on his or her worldwide income and capital gains. Income from all sources is grouped together and taxed at the current income tax rates of 20% (first €34,000 for a single person) and 41% thereafter. Capital gains are taxed at 20%.

1.2.2. Is there a different tax treatment for income from different income sources?

There is no preferential income tax rate for any particular type of income.

1.3. Capital

Ireland	RELEVANT TAX PROVISIONS AND SUBSEQUENT CHANGES FOR CORPORATIONS (distinguish specific tax rates for SMEs)				
	2002	2003	2004	2005	2006
Corporate tax					
1. Tax rate					
Standard	16%	12.5%	12.5%	12.5%	12.5%
Reduced	12.5%	N/A	N/A	N/A	N/A
Minimum Tax	N/A	N/A	N/A	N/A	N/A
Special Rates	25%	25%	25%	25%	25%

<u>Ireland</u>	**RELEVANT TAX PROVISIONS AND SUBSEQUENT CHANGES FOR <u>CORPORATIONS</u> (distinguish specific tax rates for SMEs)**				
	<u>2002</u>	**<u>2003</u>**	**<u>2004</u>**	**<u>2005</u>**	**<u>2006</u>**
Non-profit tax (local tax on corporations, energy tax…)	N/A	N/A	N/A	N/A	N/A
2. Tax accounting rules	Adjust profit/loss per accounts for tax rules.	Adjust profit/loss per accounts for tax rules	Adjust profit/loss per accounts for tax rules	Adjust profit/loss per accounts for tax rules	Adjust profit/loss per accounts for tax rules
3. Depreciation	Add-back	Add-back	Add-back	Add-back	Add-back
Basis					
Methods					
Rates					
Accounting					
Intangibles					
Non depreciable assets					
4. Provisions	- Allow if present obligation of a post balance sheet event & can be estimated reliably. - Provisions	- Allow if present obligation of a post balance sheet event & can be estimated reliably. - Provisions for capital	- Allow if present obligation of a post balance sheet event & can be estimated reliably. - Provisions for capital	- Allow if present obligation of a post balance sheet event & can be estimated reliably. - Provisions for capital	- Allow if present obligation of a post balance sheet event & can be estimated reliably. - Provisions for capital

Ireland	RELEVANT TAX PROVISIONS AND SUBSEQUENT CHANGES FOR CORPORATIONS (distinguish specific tax rates for SMEs)				
	2002	**2003**	**2004**	**2005**	**2006**
	for capital expenditure are not allowed.	expenditure are not allowed.Allow if present obligation of a post balance sheet event & can be estimated reliably.	expenditure are not allowed.Allow if present obligation of a post balance sheet event & can be estimated reliably.	expenditure are not allowed.Allow if present obligation of a post balance sheet event & can be estimated reliably.	expenditure are not allowed.Allow if present obligation of a post balance sheet event & can be estimated reliably.
Risks and futures expenses	As for provisions	As for provisions	As for provisions	As for provisions	As for provisions
Bad debts	Allow specific bad debts	Allow specific bad debts	Allow specific bad debts	Allow specific bad debts	Allow specific bad debts
Pensions	Only allow payment made during accounting period	Only allow payment made during accounting period	Only allow payment made during accounting period	Only allow payment made during accounting period	Only allow payment made during accounting period
Repairs	Allow	Allow	Allow	Allow	Allow
5. Losses					
Carry forward	Against same trade indefinitely	Against same trade indefinitely	Against same trade indefinitely	Against same trade indefinitely	Against same trade indefinitely
Carry back	One year previous	One year previous	One year previous	One year previous	One year previous
Transfer of losses	Transfer same year	Transfer same year	Transfer same year	Transfer same year	Transfer same year

Ireland	RELEVANT TAX PROVISIONS AND SUBSEQUENT CHANGES FOR CORPORATIONS (distinguish specific tax rates for SMEs)				
	2002	**2003**	**2004**	**2005**	**2006**
	losses to other group members - no carry back or forward	losses to other group members - no carry back or forward	losses to other group members - no carry back or forward	losses to other group members - no carry back or forward	losses to other group members - no carry back or forward
6. Inventories					
Valuation rules	As per accounts	As per accounts	As per accounts	As per accounts	As per accounts
Allocation methods	N/A	N/A	N/A	N/A	N/A
Personal Income tax	Top Rate 42%	Top Rate 42%	Top Rate 42%	Top Rate 42%	Top Rate 42%
Interest Income	Top Rate 42%	Top Rate 42%	Top Rate 42%	Top Rate 42%	Top Rate 42%
Dividends	Top Rate 42%	Top Rate 42%	Top Rate 42%	Top Rate 42%	Top Rate 42%
Employment income	Top Rate 42%	Top Rate 42%	Top Rate 42%	Top Rate 42%	Top Rate 42%
Capital gains tax					
Sale of fixed assets	20%	20%	20%	20%	20%
Timing rules					
Accounting rules					
Inflation	Yes	No	No	No	No
Rates					
Exemptions					

<u>Ireland</u>	**RELEVANT TAX PROVISIONS AND SUBSEQUENT CHANGES FOR <u>CORPORATIONS</u> (distinguish specific tax rates for SMEs)**				
	<u>2002</u>	**<u>2003</u>**	**<u>2004</u>**	**<u>2005</u>**	**<u>2006</u>**
Sale of shares	Retirement Relief	Retirement Relief	Retirement Relief	Retirement Relief	Retirement Relief
Capital loss					
Fixed assets					
Shares					
Wages					
Average cost to the Undertaking	Deductible in full	Deductible in full	Deductible in full	Deductible in full	Deductible in full
Average cost to the employee	Taxed at marginal income tax rate	Taxed at marginal income tax rate	Taxed at marginal income tax rate	Taxed at marginal income tax rate	Taxed at marginal income tax rate
Overall tax on distributed earnings or Dividends	Taxed at marginal income tax rate	Taxed at marginal income tax rate	Taxed at marginal income tax rate	Taxed at marginal income tax rate	Taxed at marginal income tax rate
Timing	Taxed in year of receipt	Taxed in year of receipt	Taxed in year of receipt	Taxed in year of receipt	Taxed in year of receipt
Tax credit structure	See example later	See example later	See example later	See example later	See example later
Excluding non profit tax	N/A	N/A	N/A	N/A	N/A
Including non profit tax	N/A	N/A	N/A	N/A	N/A
Deduction of					

Ireland	**RELEVANT TAX PROVISIONS AND SUBSEQUENT CHANGES FOR CORPORATIONS (distinguish specific tax rates for SMEs)**				
	2002	**2003**	**2004**	**2005**	**2006**
expenses					
General rule					
Non-deductibility of expenses					
Thin capitalization	N/A	N/A	N/A	N/A	N/A
Overall corporate tax on retained earnings	16%	12.5%	12.5%	12.5%	12.5%
Excluding non profit tax	N/A	N/A	N/A	N/A	N/A
Including non profit tax	N/A	N/A	N/A	N/A	N/A
Debt financing					
Interest deductibility	Yes	Yes	Yes	Yes	Yes
Limits on interest deductibility	Generally No	Generally No	Generally No	Generally No	Generally No
Interest deductibility on business owner loan to Undertaking	Yes no restriction	Yes no restriction	Yes no restriction	Yes no restriction	Yes no restriction

Ireland	RELEVANT TAX PROVISIONS AND SUBSEQUENT CHANGES FOR PARTNERSHIPS and SOLE TRADERS (distinguish specific rates for SMEs)				
	2002	2003	2004	2005	2006
Tax applicable to partnerships					
1. Tax rate					
Standard	Partners and Marginal rates	Sole Traders	Are subject	To income	Tax at
Reduced	Rates				
Minimum Tax					
Special Rates					
Non profit tax (local tax on corporations, energy tax…)	N/A	N/A	N/A	N/A	N/A
2. Tax accounting rules	As for Companies				
3. Depreciation					
Basis	Normal	Accounting	Methods	As per	Accounts
Methods					
Rates					
Accounting					
Intangibles					
Non depreciable assets	Disallow	Disallow	Disallow	Disallow	Disallow

Ireland	RELEVANT TAX PROVISIONS AND SUBSEQUENT CHANGES FOR PARTNERSHIPS and SOLE TRADERS (distinguish specific rates for SMEs)				
	2002	2003	2004	2005	2006
4. Provisions					
Risks and futures expenses	Allow if present obligation of a post balance sheet event & can be estimated reliably.	Allow if present obligation of a post balance sheet event & can be estimated reliably.	Allow if present obligation of a post balance sheet event & can be estimated reliably.	Allow if present obligation of a post balance sheet event & can be estimated reliably.	Allow if present obligation of a post balance sheet event & can be estimated reliably.
Bad debts	Allowable if specific	Allowable if specific	Allowable if specific	Allowable if specific	Allowable if specific
Pensions	Allow payment made during accounting period.	Allow payment made during accounting period	Allow payment made during accounting period	Allow payment made during accounting period	Allow payment made during accounting period
Repairs	Allowable	Allowable	Allowable	Allowable	Allowable
5. Losses					
Carry forward	Yes against same trade	Yes against same trade	Yes against same trade	Yes against same trade	Yes against same trade
Carry back	No	No	No	No	No
Transfer of losses	No	No	No	No	No
6. Inventories					
Valuation rules	See replies	above for	companies.		

Ireland	RELEVANT TAX PROVISIONS AND SUBSEQUENT CHANGES FOR PARTNERSHIPS and SOLE TRADERS (distinguish specific rates for SMEs)				
	2002	2003	2004	2005	2006
Allocation methods					
Personal Income tax					
Interest Income	See replies	above for	companies.		
Dividends					
Employment income					
Capital gains tax					
Sale of fixed assets					
Timing rules					
Accounting rules					
Inflation					
Rates					
Exemptions					
Sale of shares					
Capital loss					
Fixed assets					
Shares					
Wages					
Average cost to the Undertaking					
Average cost					

Ireland	RELEVANT TAX PROVISIONS AND SUBSEQUENT CHANGES FOR PARTNERSHIPS and SOLE TRADERS (distinguish specific rates for SMEs)				
	2002	2003	2004	2005	2006
to the employee					
Dividends					
Timing					
Tax credit structure	N/A	N/A	N/A	N/A	N/A
Deduction of expenses	See replies	above for	companies.		
General rule					
Non-deductibility of expenses					
Thin capitalization	N/A	N/A	N/A	N/A	N/A
Retained earnings					
Debt financing					
Interest deductibility					
Limits on interest deductibility					
Interest deductibility on business owner loan to Undertaking	Yes	Yes	Yes	Yes	Yes

1.3.1. Is there a different tax treatment between distributions of earnings and capital gains realised by the sale of the business or the shares in the undertaking?

Distributions of earnings are subject to income tax at the marginal tax rate. They are also subject to social security contributions. Capital gains are subject to just capital gains tax at 20%, subject to any specific reliefs and exemptions.

1.3.2. Are there different tax treatments for long-term capital gains and short-term capital gains?

The 20% tax rate applies to long-term and short-term capital gains.

1.3.3. Are there different tax treatments for capital gain from SME business stock and capital gain from larger companies' business stock?

The same 20% tax rate applies to gains on selling shares in SMEs and larger companies.

2. What are the main types of business entities and the main differences in (corporate) income taxation for sole traders, general partnerships, limited partnerships and corporation and other business entities if relevant?

There are 5 main types of business entities in Ireland:

1) Sole Trader

An individual who carries on a trade. The business is not a separate legal entity and does not enjoy limited liability. The sole trader is personally liable for all the debts of the business.

2) Private Limited Company

A separate legal entity incorporated by the Companies Registration Office under the Companies Act 1963, which is distinct from the shareholders behind the company and enjoys limited liability.

3) Private Unlimited Company

Also a separate legal entity incorporated by the Companies Registration Office under the Companies Act 1963, which is distinct from the shareholders but does not enjoy limited liability.

4) Public Limited Company (PLC)

A company publicly quoted on a Stock Exchange whose shares may be bought by anyone.

5) Partnership

A partnership is not a separate legal entity distinct from the individuals in the partnership. It does not enjoy limited liability and the individual partners are liable for all debts of the partnership.

2.1. Are partnerships treated transparent for tax purposes?

Yes partnerships are transparent for tax purposes.

2.2. Can partnerships opt for corporate income tax?

No, partnerships may not opt for corporate tax.

2.3. Once they have opted for a regime is it easy to switch back?

N/A

2.4. Is there a difference in this respect between general and limited partnerships?

Limited partnerships are companies and pay corporation tax. General partnerships are usually individuals who pay income tax on their share of partnership profits.

2.5. Can corporations opt to be treated tax transparent?

No, corporations may not opt to be transparent for tax purposes.

2.6. Once they have opted for a regime is it easy to switch back?

N/A

2.7. Are their differences in this respect between the different types of corporations?

No there are no differences between types of corporations.

and in a table form:

	INCLUDE RELEVANT TAX PROVISIONS IN 2002 AND SUBSEQUENT CHANGES UP TO 2007			
Ireland	General Partnership	Limited Partnership	Corporation	Sole Trader
Corporate tax	N/A	12.5% general rate; 25% on passive income	12.5% general rate; 25% on passive income	N/A
Income tax	First €34,000 at 20%. Balance at 41% plus social security	First €34,000 at 20%. Balance at 41% plus social security	N/A	First €34,000 at 20%. Balance at 41% plus social security
Capital gains tax	20%	20%	20%	20%
…				
Option for				

Transparent treatment	N/A	N/A	N/A	N/A
…				

3. Are there any special tax regimes for SMEs for (corporate) income tax purposes?

YES

Explanation

Retirement relief[3] is available on capital gains from selling shares in an SME business. Such gains are exempt up to €750,000 (€1,500,000 for a husband and wife who both satisfy the necessary conditions) where the person is over 55 years old and has worked in the company for 10 years and the shares are sold to a stranger.

There is no ceiling on the relief where the shares are transferred to a child.

Additionally shares in an SME company can be transferred to a child with only 10% of the value of the company assessed for gift or inheritance tax subject to certain other conditions.

3.1. What are the conditions to be fulfilled in order to benefit from these special tax regimes?

The individual must have been a working director of the relevant[11] company for a period of at least 10 years during which he or she has been a full-time working director for at least 5 years. In addition the business assets must have been owned by the business and in use for the trade of the business for at least 10 years.

[11] Section 599 of the Taxes Consolidation Act 1997

3.2. Are there limits on the length of time during which these special tax regimes are available, or other limits?

The relief will be clawed back if a child to whom the shares are transferred sells the shares within 6 years[12].

For gift and inheritance tax purposes the shares must have been owned for at least 5 years. The relief is clawed back if the shares are sold within 6 years of the gift or inheritance.

4. Are there any special tax incentives, such as (re-) investment reserves or provisions, special depreciations/capital allowances deductible for (corporate) income tax purposes?

YES

Explanation

An investor can get tax relief at the marginal income tax rate on investing up to €150,000 per annum in qualifying companies under a regime known as Business Expansion Scheme relief[11]. The maximum investment that a company can raise through this tax-based relief is €2 million although the maximum that can be raised in any 12 months is €1.5 million. The amount that can qualify for income tax relief annually under the Seed Capital Scheme is €100,000[11].

And answering sub-questions including but not limited to:

4.1. Do these elements of internal financing represent an important alternative to the financing by retained earnings?

YES

Explanation

[12] Section 488 to 508 of Taxes Consolidation Act 1997

BES and Seed Capital would represent an important alternative to financing by retained earnings[11].

4.2. Are there any compulsory measures in relation to the retention of earnings (e.g. legal constraints for the distribution of profits and dividend policy)?

YES

Explanation and description of such measures and how they work – case study

A company is restricted from distributing profits by way of a dividend to the shareholders of the company, which are in excess of the reserves of the company, i.e. a proposed dividend cannot exceed the reserves of the company, and a company cannot pay a dividend if it has negative reserves.

5. Are there any differences in the tax treatment of stock and cash dividends?

NO

Explanation

Both are subject to income tax at the marginal income tax rate.

6. Have there been any changes in the tax regulation in recent years - since 2002 – that have had an important effect on the retention of earnings, the distribution earnings or the reinvestment of profits for a particular purpose?

YES

Explanation and comment of table under Question 1

The reduction of the general corporation tax rate to 12.5%.

The abolition of the need to purchase an annuity with retirement funds and the additional scope for owners of SME to get a deduction for pension payments.

7. Are there any current plans for tax reforms that have as their object to have an impact on the retention of earnings?

The recently published Finance Bill 2008 did not contain any measures that would impact on the retention of earnings. We are not aware of any current plans in this area.

PART 2 – TAX ASPECTS OF RETAINED EARNINGS VERSUS DISTRIBUTED PROFITS AND WAGES

8. What is the tax treatment of retained earnings compared to distribution of earnings on the level of the Undertaking and at a combined level of Undertaking (corporate) and business owner (individual)?

Leaving profits accumulate at 12.5% and subsequently liquidating the company produces an overall tax rate of 30%.

Taking maximum salary and avoiding corporation tax produces a combined income tax and social security cost of 44%.

Distributing after tax profits produces an overall tax and social security cost of 52.80%.

See table below.

	Accumulate and Liquidate	Take Maximum Salary	Take Maximum Dividends
	€	€	€
Company Earnings	100	100	100
Salary	0	(95)	0
Social Security	0	(5)	0
	0	(100)	0
Taxable	100	0	100
C.T. at 12.5%	(12.50)	0	(12.50)
Net	**87.50**	**0**	**87.50**
Salary	0	95	0
Dividend	87.50	0	87.50

	Accumulate and Liquidate	Take Maximum Salary	Take Maximum Dividends
	€	**€**	**€**
Tax			
Capital Gains Tax	(17.50)	0	0
Income Tax	0	39	35.90
Social Security	0	0	4.40
Net	**70.00**	**56.00**	**47.20**
Overall Tax			
Company	12.50	0	12.50
Individual	17.50	39	35.90
Social Security	0	5	4.40
Total Tax	**30.00**	**44.00**	**52.80**

8.1. Is there an economic double taxation of distribution of earnings (taxation of Undertaking income and then taxation on the distribution of earnings at the Undertaking level or at the business owner level)?

YES

Explanation through case study

There is double taxation when earnings are distributed as no part of the corporation tax payable by the company can be credited against the income tax liability of the owner in respect of the dividend.

and in a table form:

	INCLUDE RELEVANT TAX PROVISIONS IN 2002 AND SUBSEQUENT CHANGES UP TO 2007	
Ireland	**Undertaking**	**Individual Business owner**
Corporate tax	12.50%	N/A
Income tax	N/A	First €34,000 at 20% and balance at 41% plus social security
Dividend tax		First €34,000 of all income, (including dividends) at 20% and balance at 41% plus social security
Dividend credit	N/A	N/A
Capital gains tax	20%	20%
If option for Transparent treatment chosen	N/A	N/A

9. **Please describe the differences in the tax treatment of distribution of earnings realised as a capital gain in the context of a sale of the shares or of the business compared to that (i) of retained earnings, (ii) of wages salaries paid to the business owner and (iii) of a loan granted by the Undertaking to the business owner?**

Explanation and description of special treatment if any (case study)

Leaving profits accumulate at 12.5% and subsequently liquidating the company produces an overall tax rate of 30%.

Taking maximum salary and avoiding corporation tax produces a combined income tax and social security cost of 44%.

Distributing after tax profits produces an overall tax and social security cost of 52.80%.

A loan granted by the Undertaking to the business owner triggers tax consequences under close company legislation. This legislation imposes an obligation on the Undertaking to withhold income tax at 20% on such a loan if it is not repaid within six months of the accounting year-end.

10. Is the combination of wages (paid to the business owner by the Undertaking), profit distributions and retained earnings a tax planning issue that is anticipated and addressed by business owners in view of minimising the overall tax burden of the business owner and the Undertaking?

YES

Explanation

Very often this decision centres on planning to pay little or no corporation tax as this is viewed as “dead”. This planning is facilitated by the generous amount of pension payments that owners of SMEs can make that are fully tax deductible. The combination of salary and pension payments can eliminate the corporation tax liability in most cases.

11. In respect to the previous question, is the business owner more interested in minimising his/her tax burden and then the Undertaking’s or both equally?

Explanation

Minimising his or her tax burden principally, as the income tax rate (up to 46%) is higher than the corporation tax rate of 12.5%.

12. Are there instances in which minimising the tax burden of the business owner would mean dramatically increasing the tax burden of the Undertaking?

Explanation and case study

Not really given the low corporation tax rate of 12.5%. In any event, the owner's tax burden can be kept low and the corporation tax liability eliminated through pension contributions.

13. For corporate income tax or capital gains tax purposes, are there any incentives/disincentives to retain earnings rather than distribute them or pay wages?

It depends on the individual company.

Because the CGT rate of 20% is lower than the marginal income tax and social security rate (up to 46%), there is an incentive to retain earnings rather than pay dividends. When a company is wound up by liquidation, capital gains tax of 20% is paid by the shareholders of the company on the capital distributions received by them, whereas dividends received by the shareholders (other than on a liquidation of the company) are liable to income tax at up to 46%. The retirement reliefs are also another factor in retaining rather than distributing earnings.

There are disincentives for close companies in retaining certain earnings, as mentioned in paragraph 1.1.1 above.

13.1. Are there any limitations or ceilings for these incentives?

NO

Description

There is no ceiling on gains that can be taxed at the capital gains tax rate of 20%.

*13.2. **Is there a risk that these incentives can be used more than one time by the business owners by splitting up the business activities into different legal entities?***

NO

Description via case study

There are anti-avoidance tax rules[13] aimed at artificial schemes that try to convert earnings that would normally be taxable at income tax rates into capital gains taxable at 20%.

14. What is the tax treatment of declared loans granted by the Undertaking to the business owner?

The company is obliged to pay over tax equivalent to 20% of the "gross" loan advanced. For example if the owner receives €80, then the company must pay over €20 in tax. This €20 tax is refunded when the loan is repaid. If not repaid, then the amount received is treated as a distribution and subjected to tax in the owner's hands accordingly.

Description and case study (unless already provided under Question 10) and answering sub-questions including but not limited to:

*14.1. **Is there a minimum interest rate to be charged for tax purposes?***

No there is no minimum interest rate.

*14.2. **How is the interest rate treated for tax purposes for the Undertaking?***

[13] Section 817 of the Taxes Consolidation Act 1997

N/A

14.3. How is the interest rate treated for tax purposes for the business owner?

The business owner is taxed on the loan as a benefit-in-kind for income tax purposes at the following rates:

a) If loan is used to acquire principal private residence - the rate is 4.5% for 2007[14].
b) If loan is used for any other purpose – the rate is 12% for 2007[13].

14.4. What are the combined tax effects of such a loan compared to a distribution of earnings equivalent in amount?

The tax effects are the same when loan is written-off. Until such time, the extra costs are the tax deposited by the company, and the benefit-in-kind suffered by the owner.

15. Are there any other taxes (e.g. net worth tax), which are imposed or based on the net equity of the Undertaking?

NO

16. Are there any other tax incentives for either the retention of earnings or their distribution of profits?

NO

[14] Section 122 of the Taxes Consolidation Act 1997

PART 3 – TAX ASPECTS OF RETAINED EARNINGS FINANCING VERSUS DEBT FINANCING

17. In debt financing, what is the tax treatment of interest expenses paid or accrued by the Undertaking?

Explanation and description of special treatment if any (case study)

The general position is that interest expense incurred for business purposes is allowed without restriction.

And answering sub-questions including but not limited to:

17.1. Is there a different tax treatment to deductions on interest paid when the lender is a resident or a non-resident for tax purposes?

No, but there may be withholding tax obligations if the lender is non-resident.

17.2. Is there a different tax treatment on interest on long-term debt and interest on short-term debt?

No, there is no difference in the treatment of interest on long-term and short-term debt.

18. Are there any tax benefits that are actionable based on specific amounts of equity (e.g. notional interest expense based on the increase of own equity or the total amount of equity)?

Explanation and case study

No

And answering sub-questions including but not limited to:

18.1. What is the exact calculation method used to implement this incentive and to evaluate the benefits once this incentive is implemented?

N/A

18.2. Are there any other tax provisions favouring increases in own equity?

NO

19. Is debt financing of an enterprise by the business owner himself of his/her family recognised for tax purposes (i.e. If the business owner or his/her family lends money to the Undertaking are they treated differently than other lenders for tax purposes)?

YES

Explanation

The owner will receive a tax deduction for interest paid on loans provided by him or her for use by the undertaking for trading purposes.

19.1. If so, are there any incentives for the business owners to debt-finance their enterprise instead of retained earnings financing or equity financing?

The interest relief gives rise to a tax saving at marginal income tax rate of 41%, as opposed to 12.5% if the borrowing is done by the company. The preference would be for the company to borrow, but the fact that tax relief is available personally to the owner is attractive and important.

20. Is there a general discrimination between retained earnings financing and debt financing from a tax point of view?

YES

Explanation

Interest relief only applies to debt financing.

20.1. Is there a general discrimination between retained earnings financing and equity financing from a tax point of view?

No

20.2. Is there a general discrimination between equity financing and debt financing from a tax point of view?

YES

Explanation

Interest relief only applies to debt financing.

21. Are there any debt to equity ratios limiting the deductibility of interest expenses for tax purposes?

In general there are no debt/equity ratio limitations but see below in question 21.1 for interest paid on loans from directors or directors' associates.

And answering sub-questions including but not limited to:

21.1. If so, does the limitation apply to loans granted by the business owner and affiliated persons or does it include loans granted by third parties?

Section 437 (TCA 1997) restricts the interest relief to 13% on loans from directors and directors' associates to an amount equal to 13% of the lesser of:

(a) the total of all loans from directors and directors' associates, and

(b) the nominal issued share capital of the company plus the share premium.

21.2. What are the consequences if the debt to equity ratio is not respected?

Explanation, description of the ratio and case study

The excess interest is treated as a distribution and is not deductible.

22. Are there any tax provisions likely to impact the conversion of retained earnings into share paid in capital (For example share buy-back)?

NO

Explanation

Capital duty has recently been abolished so this disincentive to increase the share capital is gone.

And answering sub-questions including but not limited to:

23. Are there any other taxes that have as their object to affect or impact on either Undertaking debt financing or retained earnings financing?

NO

PART 4 – TAX ASPECTS OF BUSINESS INCOME VERSUS PRIVATE INCOME

24. In respect to individual business owners, what is the general tax treatment for private (i.e.: interest on passive investment) income compared to business income (i.e.: income generated from your business activity)?

Description and case study

Taxed at the same marginal income tax rate. No pension payments can be made in respect of passive i.e. unearned income.

and in a table form:

	INCLUDE RELEVANT TAX PROVISIONS IN 2002 AND SUBSEQUENT CHANGES UP TO 2007	
Country - Ireland	Private Investment Income	Business Income
2007	First €34,000 at 20% & balance at 41% plus social security. .	First €34,000 at 20% & balance at 41% plus social security.
2006	First €32,000 at 20% & balance at 42% plus social security.	First €32,000 at 20% & balance at 42% plus social

	INCLUDE RELEVANT TAX PROVISIONS IN 2002 AND SUBSEQUENT CHANGES UP TO 2007	
Country - Ireland	Private Investment Income	Business Income
		security.
2005	First €29,400 at 20% & balance at 42% plus social security.	First €29,400 at 20% & balance at 42% plus social security.
2004	First €28,000 at 20% & balance at 42% plus social security.	First €28,000 at 20% & balance at 42% plus social security.
2003	First €28,000 at 20% & balance at 42% plus social security.	First €28,000 at 20% & balance at 42% plus social security.
2002	First €28,000 at 20% & balance at 42% plus social security.	First €28,000 at 20% & balance at 42% plus

	INCLUDE RELEVANT TAX PROVISIONS IN 2002 AND SUBSEQUENT CHANGES UP TO 2007	
Country - Ireland	Private Investment Income	Business Income
		social security.

There are certain types of investment where the tax treatment differs with whether the investor is an individual or a company.
For example interest on bank deposits is subject to a final tax at the standard rate (currently 20%) in the hands of a individual. Such interest received by a company is subject to corporation tax at 25%.
Additionally Ireland also has what is known as a "gross roll-up" regime for investments in funds[15] with final liability exit taxes of 20% and 23% applying to payments received by certain individuals. For trading companies investing in such funds, tax at the standard rate of 20% is deducted by the investment undertaking from the amount paid to the company. The trading company then includes the gross amount in its corporation tax return with a credit for the tax already deducted by the investment undertaking at source.

and answering sub-questions including but not limited to:

24.1. Are there different allowances or special treatments for private investment income and business income?

NO

25. Is there a different tax treatment for interest income received in a private investors capacity (ie: business owner investment return in another

[15] Section 739 of the Taxes Consolidation Act 1997

Undertaking) and interest income earned through business activity (i.e.: business owner investment return from the Undertaking)?

No, any interest income earned by an individual is taxed at either the standard or top rate of income tax depending on the individual's total income for the relevant tax year.

26. Does the tax system encourage business owners to invest in private assets, which are subsequently rented or leased to their enterprises?

YES

Explanation

The interest expense can be set off against the rents from the property rented to the undertaking. Owning property assets avoids a double charge to capital gains tax when the owner wants to get the cash from the sale of the property into his or her own hands.

27. By opposition to Question 26, does the tax system encourage that assets be acquired by the Undertaking and rented or leased to the business owner?

NO

Explanation

Rental payments by the owner to the undertaking would have to be funded out of after-tax income at a marginal tax rate of possibly 41%.

28. Are capital gains from private assets taxed in the same way as capital gains realised within the context of a business activity?

YES

Explanation and case study

The same rate of 20% applies but the retirement reliefs mentioned above only apply to business assets and shares.

<u>and answering sub-questions including but not limited to:</u>

28.1. If capital gains from private assets are taxed lower, does this represent an important incentive for the business not to invest in their own Undertaking?

N/A

<u>Explanation</u>

Capital gains tax rate is the same for disposals of all assets i.e. 20%

29. Are interest expenses incurred on private debts deductible for tax purposes?

NO

<u>Explanation</u>

Generally no, but interest expense on a loan to acquire a property for renting is available for offset against the rental income.

30. Is there a tax advantage for the Undertaking in transferring debts from the business owner to the Undertaking?

NO

<u>Explanation and case study</u>

Tax relief in the company is at 12.5% as opposed to 41% by the owner, so no.

31. Is there a tax advantage for the business owner in transferring debts from the business owner to the Undertaking?

NO

32. Are there other taxes such as inheritance tax, which have an important impact on own equity and retention of earnings decisions?

YES

<u>Explanation and case study</u>

There are generous reliefs from gift and inheritance tax on the transfer of shares in a business to children as discussed in the Executive Summary i.e. 90% of the value is not taxed.