

This page shows the article as it originally appeared in the newspaper. The article itself can be read on the following page.



This is the article's web address for reference.

<http://www.irishtimes.com/newspaper/archive/1991/0403/Pg013.html#Ar01300>

The User may not copy, reproduce, distribute, or create derivative works from the Content without expressly being authorised to do so by the relevant copyright owner. © Copyright 2007 ireland.com. All Rights Reserved.

US tax changes will hit multinationals in Ireland

*Mr Finbarr
Bradley, at
Dublin City
University. —
(Photograph:
Matt
Kavanagh)*

LONG-AWAITED new tax rules from the US authorities, which will directly affect investment by US firms in Ireland, are expected to be published within months.

It appears that intense lobbying from US multinationals and foreign governments, including the Irish government and the IDA, has succeeded in persuading the US tax authorities to tone down the proposals, which in their original form could have severely hit US investment here. But close attention will still be paid to the exact form of the new legislation which could still hinder the IDA's drive to attract companies from the United States.

Direct foreign investment has been the cornerstone of Irish industrial development policy for the past 30 years.

Almost 1,000 firms, half from the USA, have set up operations since 1960 and about 40 per cent of the manufacturing workforce now work for overseas companies. Total outflows of profits, dividends and royalties climbed from £360 million in 1981 to £2,337 million in 1989.

In 1988, the Internal Revenue Service (IRS), the US tax authority, issued a White Paper aimed at reducing profits made by US companies in low-tax countries like Ireland and diverting these to the US. Since the US corporate tax rate of 34 per cent is more than three times the 10 per cent Irish rate, this would result in far higher taxes for US companies. The initial proposals would have had serious implications for Ireland.

The IRS argues that US companies rig transfer prices, those used for intercompany movements of products or services, in order to maximise Irish profits. They say US companies move funds here by charging Irish affiliates low prices for raw materials or buying finished products at high prices.

While determining the transfer price for a tangible good like a computer is difficult, it can generally be gauged from the price at which a similar product trades in the market or by estimating costs incurred before shipment.

It is less obvious how to calculate the fee subsidiaries should pay their parent companies for intangibles such as technology, patents or know-how embodied in products. The IRS argues that US firms develop products in the US, take a tax deduction for R&D expenditures, then set up an Irish operation to manufacture the product. Charging the subsidiary little for valuable intangibles reduces the IRS tax-take.

Corporations say the proposals were based on a fundamental misconception. It is wrong, they counter, to assume minimalisation of taxes is the overriding objective of international managers. Instead, organisational strategy structure and the autonomy of

The United States is about to change its tax laws to collect more of profits earned abroad by American firms. Finbarr Bradley analyses the effects on US multinationals operating in Ireland:

1981 1982 1983 1984 1985 1986 1987 1988 1989.

Source: Central Bank of Ireland, "Quarterly Bulletin", various issues.

subsidiaries are key to intercompany pricing.

Even without the complexity of different tax regimes, setting prices on which plant managers in different countries can agree is difficult. Since salaries are tied to profitability, one manager loses out if profits are shifted. So it is unrealistic that a tax director located at corporate headquarters can dictate transfer prices.

In addition, companies argue that IRS policy interferes with the fundamental right of companies to conduct internal business affairs and questioned the propriety of tax authorities making pricing decisions. By setting strict guidelines for transfer prices, IRS power is extended rather than allowing the market-place to punish inefficient behaviour.

Delays in issuing regulations were caused partly by the fact that the IRS is engaged on a second, related offensive. With increased debate in recent years about the takeover of US companies by foreigners, Congress has pressurised the IRS to increase its tax-take from this source.

For example, of the 36,800 foreign companies filing returns in 1986, more than one half reported no taxable income. In 1987, eight foreign-owned electronics firms earned a turnover of \$14 billion

but paid no federal income taxes. The IRS responded in December 1990 by imposing tough new reporting regulations, strengthening its enforcement powers and increasing the number of examiners:

In advocating various techniques for determining a transfer price, the IRS gave top priority to the exact comparable method. This was defined as the price charged an independent company for goods or services transferred

under exactly the same market and economic conditions. However, since companies especially in high-technology areas rarely sell unfinished goods to outsiders, finding exact comparables is usually not possible.

The basic "arm's length" return method was next in priority. The IRS says most Irish subsidiaries of US firms are simple manufacturing operations with little managerial or technological expertise contributed in Ireland. Under this method, foreign subsidiaries of US-owned firms would earn returns comparable to Irish-owned firms, not the high rates to which they have become accustomed. The IDA worried most about this approach.

It now appears this method will be de-emphasised in the new regulations. An alternative approach, the inexact comparable method, is preferred. This uses for reference the price a company transfers a similar rather than exactly the same product as in the exact comparable method.

A second area where the IRS appears to be easing its stance is adjustments of transfer prices over time. The IRS had proposed that a company be forced to readjust prices if market or economic circumstances significantly changed, so that even if a price set at the beginning was appropriate, should the product or technology turn out to be more profitable, companies would have to renegotiate. This is not now expected to be the norm, but, may still apply in some cases.

The authorities here will also be paying close attention to the rules on "cost-sharing" arrangements, which are the rules under which subsidiaries here contribute to the research and development costs incurred by their US parent.

The original proposals would have made life difficult for the Irish electronics and software sectors.

Here again the IRS is easing its stance, but the question is: by how much?

Finbarr Bradley is professor of finance at Dublin City University.

Profits, Dividends & Royalties Annual Outflow

