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Insight: Irish Finance Act 2019 – A Practical Guide

Bloomberg Tax, January 2020

Andrew Quinn, William Fogarty and Lynn Cramer of Maples and Calder, the Maples Group's law firm look at the measures in the Irish Finance Act which impact international investment and securitisation structures located in Ireland.

The Irish Finance Act 2019 was signed into law by the Irish President on December 22, 2019 (while the Act is now law, the final version has not yet been published on the government website).

Here we focus on the measures impacting international investment and securitisation structures located in Ireland. A number of these measures are the result of international tax initiatives such as the Organisation for Economic Cooperation and Development (OECD) base erosion and profit shifting (BEPS) project and the EU Anti-Tax Avoidance Directive (ATAD), but some are domestic Irish tax initiatives applying to securitisation companies and real estate funds.

All these new rules apply with some degree of retrospective effect, as while they apply to new structures or transactions, they may also impact a large number of existing structures and investments.

Section 110 Companies - New Provisions

Ireland is a leading jurisdiction in Europe for the location of debt issuance or securitisation vehicles. Section 110 of the Irish Taxes Consolidation Act 1997 (TCA) is the Irish tax provision that underpins the tax treatment of these companies (known as “qualifying companies” or “Section 110" companies). Section 110 companies may issue profit participating or results dependent debt instruments (referred to as “notes” hereinafter). The Finance Act introduces changes to this legislation which came into effect from January 1, 2020.

The most significant change is to the concept of “specified person” which is relevant to the ability of a Section 110 company to deduct results dependent or excessive interest payments. Where such interest is payable on notes which are structured as a quoted Eurobond, wholesale debt instrument or to a tax-exempt entity such as a pension fund, that interest will no longer be deductible if:

- it is paid to a “specified person"; and
- at the time the instrument was issued, the Section 110 company was in possession, or aware, of information which could reasonably be taken to indicate that such interest would not be subject to tax in an EU member state or jurisdiction with which Ireland has a double tax treaty (a “Relevant Territory").

A “specified person” includes a company which controls the Irish Section 110 company, is controlled by the Irish Section 110 company, or where both companies are directly or indirectly controlled by a third company. It is the change to the definition of control in this context which will impact transactions.

The new definition of control means that a noteholder could be taken to have control of the Section 110 company where that person:

- has “significant influence”, directly or indirectly, over the Section 110 company; and
- holds, directly or indirectly, more than 20% of either the issued share capital in the Section 110 company, or 20% of the principal value of profit or results dependent securities issued by the Irish Issuer, or the right to 20% of the interest on other distributions payable in respect of profit or results dependent securities issued by the Section 110 company.

In typical structures, the significant ownership test is most likely to impact holders of profit participating notes, such as the subordinated notes in a public securitisation transaction like a collateralised loan obligation (CLO) or residential mortgage-backed securities (RMBS) transaction. Where a noteholder meets the 20% ownership threshold, the question then becomes whether that noteholder has “significant influence” over the Section 110 company.

Significant influence is a new concept in Irish tax law and is defined as the ability to participate in the financial and operating decisions of a company. While there is currently no guidance on the concept, the current view is that it could cover the activities of an investment manager or collateral manager which holds a level of discretionary delegated authority to act on behalf of the Irish company. It may also apply in structures where a noteholder has direction rights with respect to certain actions of the Irish company.

The restriction on deductibility does not apply if either:

- the relevant noteholder can confirm that the interest payable on the subordinated notes is subject to tax in a Relevant Territory; or
- at the time of issuance of the relevant instrument, the Section 110 company was not in possession of any information which could reasonably be taken to indicate that the interest payable was not subject to tax in a Relevant Territory.

Investors who hold large participations in Section 110 companies and arrangers or risk retention holders should contact their advisers now to determine whether the new rules impact their structures and whether there are any steps to be taken to mitigate the impact.

Tax Treatment of Irish Real Estate Funds

Irish Real Estate Funds (IREFs) are regulated Irish funds investing in Irish property and related assets and are subject to specific tax treatment, including a potential withholding tax which applies on distributions from an IREF.

Finance Act 2019 contains further changes to the tax regime which applies to IREFs.

As currently drafted, a number of key points emerge:

- IREFs can be exposed to direct tax (not withholding tax) on deemed income if their leverage exceeds 50% of the cost of their assets. There is relief where the debt incurred qualifies as third-party debt;
- in addition, IREFs can be exposed to direct tax where their interest expense is four times their income. As above, there is a relief where the interest relates to third-party debt;
- the concept of third-party debt is narrowly defined, and it is necessary to review the purpose and use of the proceeds in order to determine the amount of relief available. Significant amounts of genuine bank debt may not qualify as third-party debt;
- non-interest expenses may lead to a further tax charge unless incurred for the purposes of the IREF's business. This could impact management fees and other similar charges.

As originally drafted, the provisions of Finance Act 2019 did not include an exemption for third-party debt, so the exemption is to be welcomed. However, the reality is that the narrow nature of the definition will restrict and complicate the ability of an IREF to avail of the exemption, even if this is part of a bona fide borrowing arrangement.

Additional anti-avoidance and compliance obligations are included within the Act. The legislation illustrates a policy aimed at dissuading the widespread use of IREFs as vehicles for investment and property activity. The tax advantages in using IREFs have been substantially eroded over the last three years.

Although in principle, an IREF may still be attractive to EU pension funds, provided they operate with low levels of leverage, navigating the provisions to reach a conclusion on such a structure will be challenging. Investors who are impacted by the 50% test and the excess interest limit will consider converting debt into equity.

The Irish Minister for Finance has noted that he will continue to review the tax treatment of IREFs and is open to further legislative amendments if he perceives the IREF regime being used for ongoing tax avoidance. It would not be surprising if, either as part of this legislative process, or in 2020, further changes are introduced. This creates a climate of considerable uncertainty which restricts the ability to model the impact of the tax changes.

Investors, lenders and managers of IREFs should consider the impact of the changes on their structures including:

- examining the impact of the tax imposed based on the current debt and expense structure;

- determining whether third party debt, including bank debt, qualifies for relief, based on the history of the borrowing;
- where possible, restructuring excess debt to return it to equity; and
- examining banking covenants in order to determine the consents required to adapt the structure.

EU Anti-Hybrid Rules

ATAD requires the introduction by all EU member states of anti-hybrid rules. Ireland has included the draft legislation implementing these rules in Finance Act 2019. The new rules apply to payments made on or after January 1, 2020 and there is no "grandfathering" relief for existing structures. As such, there is an element of retrospectivity in this context also.

The anti-hybrid rules are intended to prevent arrangements that exploit differences in the tax treatment of a financial instrument or an entity under the tax laws of two or more jurisdictions to generate a tax advantage, i.e. a "hybrid" situation.

The rules apply only in certain circumstances:

- to arrangements between associated enterprises. For this purpose, an entity is associated with another entity if it holds a certain percentage (25% or 50% depending on the particular provision) of the shares, voting rights or rights to profits in that other entity, or if there is another entity that holds that percentage in both entities;
- where two entities are included in the same consolidated financial statements;
- where one entity has significant influence in the management of the other; and
- to a "structured arrangement" that is not between associated entities, where a mismatch outcome is priced into the terms of an arrangement or an arrangement is designed to produce a mismatch outcome.

The definition of significant influence in the context of the anti-hybrid rules is narrower than that included in the new definition of specified person but is still similar. It means the ability to participate on the board of directors in the financial and operating decisions of an entity.

One interesting question, which is the subject of discussion and analysis at the moment, is whether debt instruments which have an interest coupon that is referable to the retained profits of the issuing entity constitute rights to the profit of the issuing entity, which would give rise to association for the purposes of the rules. Neither the Irish draft legislation nor ATAD contain a definition of profits for these purposes.

Holdings of profit participating notes in Irish securitisation vehicles will want to take advice on this point and on the application of the rules more generally.

The rules are of particular relevance for Irish companies used in fund and financing structures as those structures will generally involve a tax deduction for the Irish company.

It is important to note that the Irish rules do not require the denial of a deduction if the reason a payment is not taxed is because the other territory does not impose tax or does not generally impose tax on payments received from outside the territory, or if it exempts the payee from tax which generally applies within the territory.

The rules are highly complex and will need to be considered in any international financing structure, especially where an Irish company is making deductible payments such as under debt funding. In particular, U.S. investors who make use of the U.S. check-the-box elections will need to consider whether those elections may result in an entity being treated as a hybrid entity.

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