Anna Holohan
Tax Senior Manager, Deloitte Ireland LLP

Finance Act 2019: The Irish Securitisation Tax Regime - Changes to s110 TCA 1997

Introduction

Ireland has had a securitisation tax regime for a number of years, which is largely contained in s110 TCA 1997. That section was introduced by Finance Act 1991 with the aim of facilitating securitisation activities in Ireland, and after its introduction Ireland quickly established itself as one of the leading locations in Europe for securitisation activity. Over the years, we have seen various Finance Acts make amendments/updates to s110 TCA 1997, most notably Finance Act 2011 and Finance Act 2016. Finance Act 2019 continued this trend, and we saw two updates introduced to the anti-avoidance measures in s110 TCA 1997.

Securitisations and s110 TCA 1997

Before delving into the changes, it is important to understand what securitisation involves and how the taxation regime for s110 companies applies. Securitisation activities in Ireland typically involve investors using s110 companies to hold/manage a variety of qualifying assets, which include a wide range of financial assets (such as shares, bonds, derivatives, loans and deposits), commodities, and plant and machinery. Typically,

profits/gains from such assets are collected in the s110 company and are paid to investors by way of interest payments and/or principal repayments.

There are a number of conditions for a company to be considered a qualifying s110 company. Broadly, where such conditions are met, the taxation regime set out in s110 TCA 1997 applies.

Qualifying s110 companies are subject to tax under Case III at the 25% rate of corporation tax. However, s110(2)(a) TCA 1997 outlines that "the profits or gains shall be computed in accordance with the provisions applicable to Case I". Therefore, although the profits of s110 companies are taxable at the higher rate of corporation tax, the computational rules that apply to trading companies are followed (i.e. a deduction is available for normal trading expenses). In addition to a deduction for normal trading expenses, s110 TCA 1997 generally provides for a deduction for all interest payable, even where a profit-participating element is included (provided certain conditions are met). This is unusual as, under general taxation rules, a profit-participating element of a payment would normally be treated as a non-deductible distribution and could be subject to dividend withholding tax. However, s110 TCA 1997 contains anti-avoidance provisions that seek to limit the deductibility of the profit-participating interest payments. These provisions were strengthened by the Finance Act 2019 amendments.

Background to Finance Act 2019 Changes to s110 TCA 1997

As part of Finance Act 2019, revised transfer pricing rules were introduced that formally adopted the 2017 OECD Transfer Pricing Guidelines into Irish legislation. This change broadened the application of transfer pricing in Ireland to bring within the scope of the rules non-trading transactions subject to certain limited exceptions. Previously, although not covered specifically in the previous transfer pricing legislation, s110 companies would not have been regarded as qualifying companies if they entered into a transaction or arrangement that did not comply with the arm's length principle subject to certain circumstances where the principle could be disapplied. The new rules will now apply to s110 companies with an important exclusion in respect of profit-participating notes issued by such companies.

The main implication in practice of the new rules applying to s110 companies is increased documentation requirements, as it has always been a requirement of s110 TCA 1997 that all transactions/arrangements are undertaken by way of a bargain made at arm's length (with the exception of certain profit-participating interest payments). The Explanatory Memorandum to Finance Bill 2019 noted that there was a carve out for profit participating notes:

> *"Revised transfer pricing rules are being introduced in Finance Bill 2019, however the profit participating note in section 110 companies cannot be made subject to the new transfer pricing rules without introducing a direct conflict in legislation. They are therefore being carved out from transfer pricing rules, but additional anti-avoidance provisions are being introduced in the Bill in tandem with this provision in order to strengthen the existing protections against abuse of the regime."*

A carve out was required as the application of transfer pricing rules to these securitisation vehicles would have created a potential conflict as the interest paid on these profit participating notes would not be compatible with the arm's length transfer pricing principle. This arises as the interest paid on these profit participating notes could be seen as an equity return as the return is not guaranteed and can depend on the performance and/or returns generated by the underlying portfolio.

It is clear from the above that the changes to the transfer pricing rules were not intended to conflict with the operation of a profit-participating element in a structure as provided for by s110 TCA 1997. In fact, s110 TCA 1997 was specifically updated to include sub-section (2)(d) to ensure same. However, the exclusion from the application of transfer pricing rules of the profit-participating element of such structures has necessitated the extension of the anti-avoidance rules, as below.

What Changed in s110 TCA 1997?

Finance Act 2019 introduced two changes to the anti-avoidance measures in s110 TCA 1997:

- broadening of the definition of a "specified person" and
- extending the scope of the specific anti-avoidance provision, sub-section (5) of s110 TCA 1997.

As mentioned above, the Explanatory Memorandum to Finance Bill 2019 clearly outlined that the changes to the anti-avoidance provisions were made "in order to strengthen the existing protections against abuse of the regime". There may be an expectation that such protection against abuse of the regime will increase the tax take from s110 companies. It is also interesting to note that, per the "Budget 2020 Tax Policy Changes" document prepared by the Department of Finance, the expected yield from the Irish real estate funds and s110 anti-avoidance measures combined with measures affecting real estate investment trusts is €80m.

We await guidance from Revenue in respect of the updates, and the exact operation of the measures and the way in which they are interpreted by Revenue are yet to be seen. However, a short summary is provided below.

Specified persons

As mentioned above, s110 TCA 1997 contains anti-avoidance provisions that seek to limit the deductibility of certain profit-participating interest payments. A deduction for interest payable on a profit-participating note to certain connected parties, known as "specified persons", is not available in defined circumstances. Although the concept of "specified persons" had already been included in s110 TCA 1997, Finance Act 2019 widened the definition.

The circumstances in which a deduction would be denied include:

- where interest is payable to a tax-exempt person, e.g. a pension fund or government body, that is considered to be a "specified person"; and
- where interest is payable on a specified instrument (e.g. listed debt, wholesale debt instrument), the recipient is a "specified person" and the s110 company is, or is deemed to be, aware that the interest would not be subject to tax in a relevant territory (EU/tax treaty), which generally applies to such interest without reduction computed by reference to such interest/distribution.

Broadly, Finance Act 2019 brought about two changes to the definition of "specified persons". The first widened the definition to include "a person, or persons who are connected with each other... to whom loans or advances held by the qualifying company were made...". The second broadened the definition of "control" under s110 TCA 1997. The concept of control has to date used the definition in s11 TCA 1997, thereby referring to share ownership/possession of voting power or powers conferred by the company's articles of association or other documents regulating the company.

As control is mentioned a number of times in the definition of specified persons, the widening of this definition in Finance Act 2019 expands the range of persons that can be considered "specified persons". The result is that a "specified person" will now include a person who has "significant influence" over the company and holds, directly or indirectly, more than:

- 20% of the issued share capital of the company,
- 20% of the principal value of a profit-participating note issued by that company, or any such securities where those securities have no principal value, or
- the right to 20% of the interest or other distribution payable in respect of the profit-participating note issued by that company.

"Significant influence" has been defined to mean "a person with the ability to participate in the financial and operating decisions of a company". It is interesting that a similar term – "significant influence in the management of" – is used in the new anti-hybrid legislation, also introduced by Finance Act 2019. However, the definition in s110 TCA 1997 is wider as it does not limit significant influence to the "board of directors or equivalent governing body" having the ability to participate in the financial and operating decisions of the entity.

As already mentioned, although the concept of "specified persons" had already been included

in s110 TCA 1997, Finance Act 2019 widened the definition, and therefore the number of entities that may be affected by the anti-avoidance provisions has likely increased. The importance of these changes is that they could result in the denial of a deduction for certain interest payments in structures where typically a deduction would have been available, because the structures are now considered to be making interest payments to a more widely defined "specified person".

It is important to note that although Finance Act 2019 made amendments to the definition of a specified person, the tax treatment of a specified person has not changed. The denial of a deduction results in such interest payment being re-characterised as a distribution, with the impact that dividend withholding tax obligations would need to be considered.

A number of issues have also been highlighted by various industry bodies – in particular, the treatment of carried interest and catch-up payments in limited partnership structures. It is expected that any guidance provided by Revenue will address the issues arising.

Anti-avoidance: s110(5) TCA 1997

The second measure relating to s110 TCA 1997 that was included in Finance Act 2019 was the amendment to the anti-avoidance provision in sub-section (5), which previously read:

> *"Subsection (4) shall not apply in respect of any interest or other distribution as is paid by a qualifying company where the qualifying company concerned is, at the time of the payment, in possession, or aware, of information that can reasonably be taken to indicate that the payment is part of a scheme or arrangement the main benefit or one of the main benefits of which is the obtaining of a tax relief or the reduction of a tax liability the benefit of which would be expected to accrue to a person who, in relation to the company, is a specified person."*

Sub-section (5) was updated to:

> *"Subsection (4) shall apply only in respect of any interest or other distribution as is paid by a qualifying company where it would be reasonable to consider that the payment is made, or the security to which the payment relates was entered into, for bona fide commercial purposes and does not form part of any arrangement or scheme of which the main purpose,* ***or one of the main purposes****, is the avoidance of tax* [emphasis added]."

This has legislated for principles that were introduced in 2018 to Revenue's Tax and Duty Manual Part 04-09-01. It is expected that this change will give Revenue further powers to challenge transactions where it believes that the payment of interest or the creation of the profit-participating note was not carried out for bona fide commercial purposes.

Effective Dates of New Rules

Both rules are effective from 1 January 2020 and no grandfathering provisions are provided for existing arrangements in existing structures. It is unclear if this issue will be addressed in Revenue guidance.

Conclusion

There are a significant number of corporate tax changes, both domestically and internationally, for Irish companies to grapple with at present. Whether they are considering the updated transfer pricing rules, the new anti-hybrid legislation, DAC 6 or the potential application of any future interest limitation rules, s110 companies are likely analysing and considering the application of various tax changes. As part of this review, such companies need to consider whether the updated anti-avoidance rules introduced to s110 TCA 1997 as part of Finance Act 2019 will have an impact on their transactions. As always, Revenue guidance can be a key factor in determining the application of new legislation, and the release of guidance in respect of the updated s110 provisions is widely anticipated and will be welcomed.

Read more on taxfind From Irish Tax Institute *Direct Tax Acts, Finance Act 2019; Finance Act 2019 - The Professional's Guide*