Finance Act 2016 Changes to the Irish Securitisation Tax Regime

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Background

The growth of securitisation in Ireland

Securitisation companies have historically been established to facilitate investment in pools of assets with associated secured loans such as commercial mortgage-backed securities (CMBSs), residential mortgage-backed securities (RMBSs) and collateralised loan obligations (CLOs). Cash-flows of principal and interest collected from the underlying debt are distributed to investors through the capital structure that finances the securitisation company.

Over the past 15 years, as European financial markets followed the lead of the US in embracing securitisation, Ireland has established itself as a leading centre for such activity and has generated significant domestic employment in servicing securitisation companies established here. Irish banks have, in the past, securitised some of their mortgage books to raise finance, with some banks intending to return to securitising their mortgage books in the near future.

The Irish securitisation tax regime

The main provisions governing the Irish corporation tax treatment of securitisation companies are contained in s110 TCA 1997. Broadly, profits of qualifying companies are chargeable to tax under Schedule D, Case III, at a rate of 25%; however, taxable profits are computed in accordance with the provisions applicable to Schedule D, Case I. Payments to investors – either as interest on the funding obtained by the securitisation company or under derivative contracts (e.g. total return swaps) that facilitate the purchase of the securitised assets – can be deducted in computing taxable profits if certain conditions are met. The result is that the profit and therefore the corporation tax liability tends to be small.

Securitisation in the context of Irish property

In the aftermath of the economic crisis and its impact on the Irish property market, some Irish securitisation companies were established to facilitate investment in portfolios of distressed loans secured on Irish property.

Over the past year, a significant amount of media and political attention has focused on the use of Irish securitisation companies for this purpose. In response to such commentary, Finance Act 2016 introduced changes affecting certain Irish securitisation companies that hold Irish property. This article considers the nature and the impact of the changes to the tax treatment of Irish securitisation companies.

Finance Act 2016 Changes

On 6 September 2016 the Minister for Finance, Michael Noonan TD, published proposed amendments to s110 TCA 1997, which were substantially enacted in s22 Finance Act 2016. Minister Noonan’s stated aims in introducing the amendments were to protect the Irish tax base from perceived abuse of the s110 TCA 1997 provisions in relation to Irish property transactions and to ensure that the incentives in s110 TCA 1997 are ring-fenced for bona fide securitisation purposes.

The amendments

Section 22 of Finance Act 2016 ring-fences the holding and/or managing of “specified mortgages” as a “specified property business” within an Irish securitisation company that carries on substantially no other activities, with the following defined transactions and business falling out of scope of the amendment:

- a CLO transaction,
- a CMBS/RMBS transaction,
- a loan origination business,

- a sub-participation transaction and
- activities that are preparatory to the above transactions or business.

Anti-avoidance provisions are included to ensure that the above transactions meet the regulatory standards laid down in EU Directives in relation to securitisations in order to qualify fully for exemptions from the Finance Act changes.

Where a "specified property business" exists, the expenses incurred in relation to that business must be apportioned on a just and reasonable basis as if such a business were carried on by a separate company engaged in the same activities and dealing on an arm's-length basis. The effect of this change is that any profit-participating interest or certain payments under derivative contracts (e.g. total return swaps (TRSs)) in excess of a reasonable commercial return are treated as a distribution and are therefore not deductible in computing the taxable profits of the "specified property business", as well as potentially being subject to 20% withholding tax. Ultimately, the result is an increased corporation tax liability for the Irish securitisation company, and a reduced return to the investor.

Effective date

These amendments apply to accounting periods starting on or after 6 September 2016. Where the company's accounting period begins before and ends after 6 September 2016, the accounting period is notionally split into two periods, with 5 September 2016 being the end of the first period (with the pre-Finance Act 2016 rules applying) and 6 September 2016 being the start of the second period, where Finance Act 2016 has force of law.

Exemptions

To ensure that the amendments affect only the intended types of transactions in Irish property, certain exemptions are allowed. The restriction on the deductibility of the interest expenses (or TRSs) will not apply if such interest has been subject to interest withholding tax at a rate of 20%.

In addition, interest payments or TRS amounts paid to the following recipients will continue to be fully deductible:

- an Irish-resident individual within the charge to Irish income tax or a company within the charge to Irish corporation tax on the interest;
- a Revenue-approved Irish pension fund;
- an EU/EEA-authorised pension fund that is subject to supervisory and regulatory arrangements equivalent to those in Ireland;
- an EU/EEA individual or company that is subject to tax in its home jurisdiction on its income or profits in respect of such payments, provided that the recipient is not receiving the payment under an arrangement that is intended to avoid tax and, if the recipient is a company, provided that it is carrying on a genuine economic activity in an EU/EEA state;
- an Irish investment undertaking (other than a "personal portfolio Irish real estate fund", a concept introduced in Finance Act 2016 in relation to certain types of investment funds that hold Irish property); and
- an Irish real estate fund (IREF), as per Finance Act 2016.

The Devil in the Detail

The absence of grandfathering provisions in amending tax legislation often brings about cumbersome consequences, and the Finance Act 2016 securitisation amendments are no exception. The effective date of the new provisions means that a securitisation company whose accounting year-end straddles 5 September 2016 will likely be required to retrospectively revalue the assets in its portfolio that represent a "specified property business". Although a revaluation is not a requirement of the new rules, it may be necessary in practice in some cases to support the required apportionment of expenses to that business if no alternative "just and reasonable" basis for that apportionment is available.

A further – and perhaps unintended – adverse consequence of the new rules arises from the fact that s110 TCA 1997 allows taxable profits to be computed under either International Financial Reporting Standards (IFRS) or Irish GAAP (generally accepted accounting principles, as they applied for accounting periods on 31 December 2004). Securitisation companies that carry on a "specified portfolio business" and calculate their taxable profits under Irish GAAP 2004 could potentially be more negatively impacted in 2016 and beyond than if they had elected for IFRS as their taxable basis, due to the difference between the accounting standards on the recognition of unrealised gains.

Finally, the denial of deductibility for interest or derivative payments in excess of a reasonable commercial return will likely necessitate a transfer pricing review of the company's loan agreements, to ensure clarity on what that return is.

Changes to the Notification to be Taxed under s110 TCA 1997

An additional amendment introduced in Finance Act 2016 accelerates the deadline for submission of the notification that a securitisation company must file in order to fall within the provisions of s110 TCA 1997. Previously, the notification could be made at any point on or before the due date of the first corporation tax return. Finance Act 2016 brings forward that deadline to within eight weeks of the first qualifying transaction of the securitisation company.

Where the first qualifying transaction took place before 1 January 2017 and the company had not made the required notification by that date, the deadline is accelerated to eight weeks from 1 January 2017 (i.e. 24 February 2017, as 26 February 2017 falls on a Sunday). Furthermore, the notification must now contain certain details relating to the type of securitisation transaction undertaken, the types of assets acquired, the originator of the assets, as well as details of transactions inter-group or with connected parties. Therefore, the accelerated notification procedure should be factored into any future securitisation transaction timeline. At the time of writing, Revenue have not published the new notification forms and as a result, it is hoped that a temporary extension may be allowed.

Conclusion

It is vital for Ireland to have the highest standard of regulation, tax infrastructure and business environment. That is the basis of our global reputation and is non-negotiable.

It is understandable that Ireland would seek to reclaim taxing rights on Irish real estate in line with many other global economies, but could the Finance Act 2016 changes lead to unintended side effects? The absence of grandfathering provisions in the amendments to limit their retrospective impact is unhelpful. In the context of Brexit, in particular, the amendments raise questions about Ireland's potential to attract continued investment from UK pension funds and UK life assurance companies, given that the exemptions are based on investors being located in the EU/EEA. Furthermore, the increasing likelihood of a "hard Brexit" may lead to the migration of some employment from the UK to Ireland, so the availability of non-bank finance to support the development of office space will be a driver of the extent to which Ireland can support such a displacement.

Investment in Irish property-related financing assets has not traditionally been the focus of Irish securitisation companies. Those that have made such investments have provided much-needed financing to support the recovery of the Irish property market. With that market recovery still continuing and with Brexit looming large on the horizon, Ireland needs to maintain its reputation as a stable and competitive location for financial services.

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