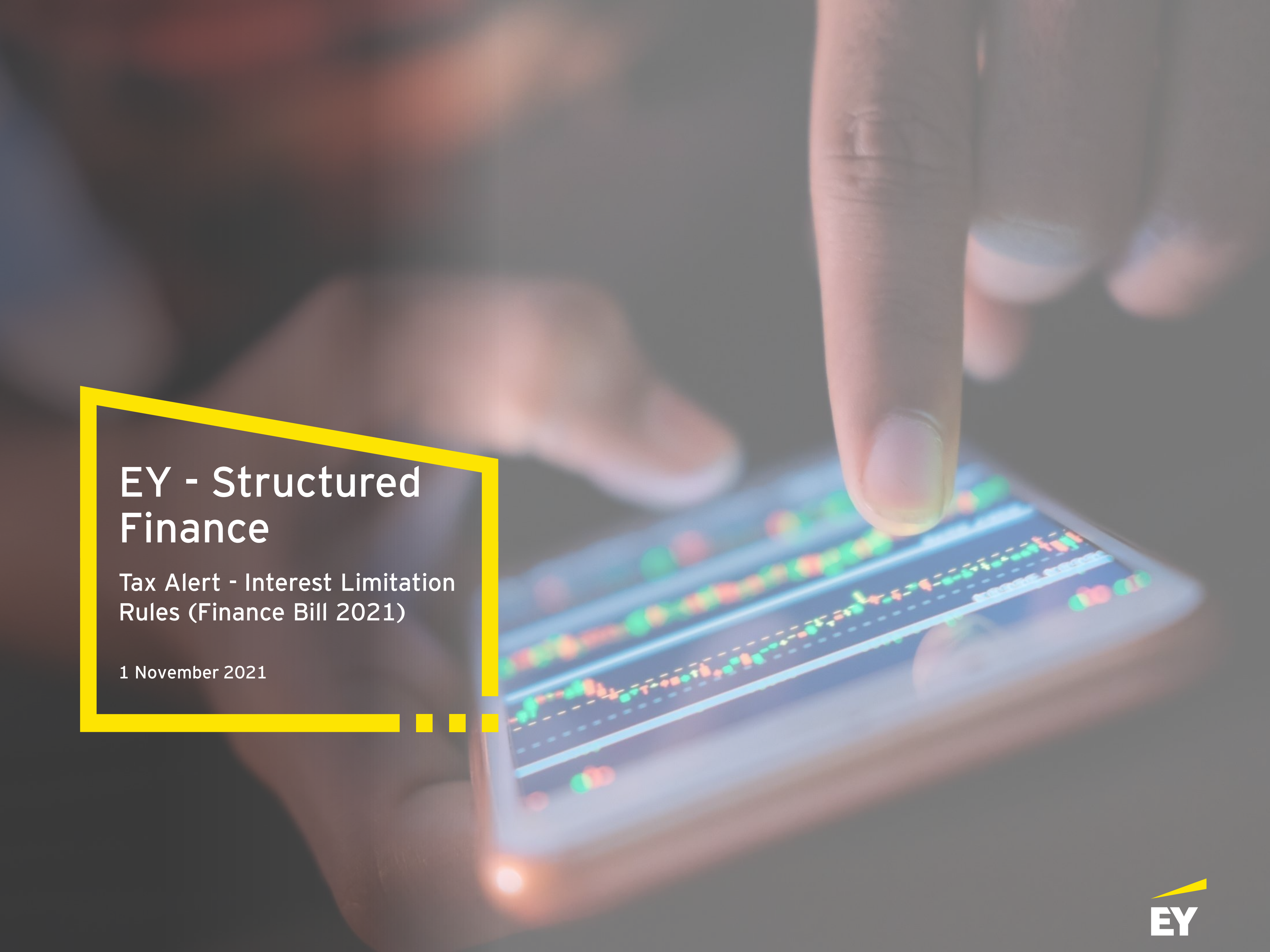


EY - Structured Finance

Tax Alert - Interest Limitation Rules (Finance Bill 2021)

1 November 2021

Interest Limitation Rules (Finance Bill 2021)

1. Quick recap

- The EU Anti-Tax Avoidance Directive ("ATAD") requires EU Member States to implement a fixed ratio rule, designed to limit the ability of entities to deduct for tax purposes net borrowing costs in a given year to a maximum of 30% of Earnings Before Interest, Tax, Depreciation and Amortisation ("EBITDA").

2. The Basics

- The interest limitation rules ("ILR") only limit an entity's net interest deductions (i.e. interest expense in excess of interest income). The rules do not restrict the ability of multinational groups to raise third party debt centrally in the country and entity which is most efficient taking into account non-tax factors such as credit rating, currency and access to capital markets, and then on-lend the borrowed funds within the group to where it is used to fund the group's economic activities.

- EBITDA is used as a guide to the ability of an entity to meet its obligations to pay interest. It is also a measure of earnings which is often used by lenders in deciding how much interest expense an entity can reasonably afford to bear.

- In order to reduce the administrative and compliance burden of the rules, ATAD allows Member States to include a de minimis threshold, below which full deductibility of exceeding borrowing costs is always permitted. This amount will be €3 million in Ireland per taxpayer (see further detail below in section 3).

2. The Basics (Continued)

- In addition, there are "group ratio" tests included in the rules which seek to provide some relief to taxpayers on the fixed ratio test where the taxpayer can demonstrate a higher level of debt leverage on a group basis than an entity basis. Recognising that some groups are highly leveraged with third party debt for non-tax reasons, the rules will provide some flexibility by disapplying the fixed interest restriction noted above under an "Equity Escape" rule and/or a "Group Ratio" rule. The below summarises how the rules apply (further commentary in section 3 below).

Equity Escape Rule

- Calculate ratio of Equity to Total Assets for entity and for the wider worldwide Group.
- No restriction on interest deduction where entity level ratio is equal to (with a tolerance of 2 percentage points) or higher than the equivalent ratio for the group.

Group Ratio Rule

- Calculate ratio of Group third party borrowings to Group EBITDA.
- Compare ratio calculated above with the fixed ratio (30%). If higher than 30%, apply the higher ratio in calculating any restriction.

- Broadly speaking, the interest restriction calculation involves the following steps:

(1) Calculate measure of EBITDA → (2) Apply fixed ratio percentage (30%) → (3) Check if higher limit applies (e.g. de minimis or Group ratio). → (4) Determine maximum net interest expense → (5) Compare Net Interest Cost with maximum expense → (6) Excess net interest cost is not deducted but can be carried forward

3. What's new in the Finance Bill?

- The Irish Finance Bill ("the Bill") was published on 21 October 2021. The Bill primarily seeks to implement the tax elements of Budget 2022 measures announced on 12 October last. As expected, the Bill included Irish implementing legislation regarding ILR. Some of the key developments regarding ILR contained in the Bill are highlighted below together with comments:

Finance Bill Provision	EY Comments
Effective Date The new rules effective for accounting periods commencing on/after 1 January 2022.	We note effective for "accounting periods" commencing on/after 1 January 2022. This allows more time for modelling for entities with non 31 December year ends.
Legacy Debt Per the Finance Bill, loans entered into before 17 June 2016 are "grandfathered" under the rules. In relation to "phased drawdowns" after that date on loans entered into prior to that date, such drawdowns **will only** be grandfathered where the lender is legally obliged to make such amounts available on the happening of certain milestones set out in terms agreed before 17 June 2016.	The definition is disappointing vis a vis additional drawdowns, amounts drawn down after 16 June 2016 will only be grandfathered in very limited circumstances, even where the loan was entered into prior to then and the terms of the loan provided for additional drawdowns. The only drawdowns that will be grandfathered are those that were scheduled based on milestones. Justification for such a restrictive approach in Ireland is unclear.
Financial Undertakings EU ATAD permitted an exemption from the interest limitation rules for certain regulated vehicles ("financial undertakings"). **Irish Finance Bill does not include this exemption**.	The responses from taxpayers / practitioners to the Feedback Statements included mixed views on the inclusion of a mandatory exemption for "financial undertakings"; with an optional exemption being the preferred approach. In certain cases excluding the regulated entity in a Group (which also has non regulated entities) from the rules could impact adversely on the position in the context of the Group ratio reliefs from interest limitation rules and could also be administratively burdensome (i.e. it may be preferrable in certain specific cases to not exclude the regulated entities from the rules). We understand that the Department of Finance were not minded to implement on an "optional" basis. Instead, the "financial undertaking" carve out has been excluded altogether from the Irish rules in the Finance Bill. While this may be favoured by some taxpayers over the "mandatory" approach, an optional exclusion would have been preferred here for maximum flexibility.

3. What's new in the Finance Bill? (Continued)

Finance Bill Provision	EY Comments
De Minimis Confirmation that de minimis is €3M per accounting period of 12 months. However, once this de minimis threshold is breached, the entire amount of the exceeding borrowing costs is subject to restriction (not just the amounts in excess of the limit).	Welcome confirmation that relief should be available on a "per entity" basis (unless the company is part of an interest limitation "group"). There is nothing to suggest otherwise in the Bill.
Gains on Debts Provision for certain gains on sale of financial assets to be considered interest equivalent **(where reasonable to consider such amounts are economically equivalent to interest).**	Positive development that some element of gains on financial assets (e.g. loans) is provided for as interest equivalent; but uncertain how this applies in practice regarding proviso "reasonable to consider such amounts are economically equivalent to interest". This appears to put emphasis back on the taxpayer to take a position. Further guidance / clarity on this point would be helpful.
"Discounts" Specific provision for "discount" to be included as "interest equivalent" on securities that are "issued at a discount".	Whilst this specifically refers to discounts arising on securities issued "at a discount", in our view this should not prevent "discounts" more generally potentially qualifying as "interest equivalent", where such a discount would otherwise fall within the wider definition (e.g. within the item on profits or losses on financial assets and liabilities as noted above).
Financing Component - Lease Rental Finance component of lease rental included in the definition of interest equivalent for entities carrying on a leasing trade.	Positive development and recognises the financing return inherent in leasing businesses - particularly relevant for S.110 companies investing in Aviation assets. Taxpayers will need to assess exactly how this finance component is calculated from a practical perspective.
Spare Capacity Spare capacity is available to carry forward for 5 years.	This was well flagged in the Feedback Statement so is not surprising this time limit is included.

3. What's new in the Finance Bill? (Continued)

Finance Bill Provision	EY Comments
Group Ratio Group Ratio refers to net finance expense in the ultimate financial statements of the group (ultimate parent financial statements under GAAP or alternative standards).	This is consistent with previous "Feedback Statements" issued by Department of Finance on the rules and means the ultimate consolidated financial statements will be the focus in applying the [Group Borrowing Costs/Group EBITDA] test.
Group & Equity Ratios – Elections. Both the Group and Equity ratios require an election by the taxpayer in advance of the tax return filing deadline.	This requirement to make an election is new and it would appear it will form part of the tax return filing (in September for December year ends). There does not appear to be anything in the Bill preventing a taxpayer from electing into the Group Ratio in one year and the Equity Ratio in the next (there is a specific prohibition on electing into both in the same accounting period).
Group of One (or "Single Company Worldwide Group") included in the Bill.	This was flagged in the Feedback Statement and provides relief for an entity that is not a member of a worldwide group, is not in an interest group and is not a standalone entity. It allows such an entity access to the Group Ratio even though it is not a member of a worldwide Group. This could be relevant in very specific scenarios / structures e.g. those involving orphan s.110 entities.

3. What's new in the Finance Bill? (Continued)

Finance Bill Provision	EY Comments
Interest Group Concept of "Interest Group" included in the Finance Bill. It requires an election into the Group. The election is generally for 3 years. The "Interest Group" is effectively treated as 1 taxpayer for the purposes of interest limitation rules.	This is as expected per the "Feedback Statements" previously issued by Department of Finance. A member of a group can include any company that is within the charge to Irish corporation tax and that is either a consolidated entity in the worldwide group's financial statements or a member of an Irish tax loss group. It appears the intention is that intra group transactions would be effectively ignored for the purposes of calculating any interest restrictions. An interest group could include an Irish QIAIF (Qualifying Investor Alternative Investment Fund) established as a corporate. This may be particularly relevant for example in a S.110 / QIAIF structure. The position is less clear in relation to a unit trust.
Reporting Requirements The Finance Bill includes a list of items which may require reporting by taxpayers by the tax return filing deadline including EBITDA, exceeding borrowing costs, disallowable interest, spare capacity, carry forward amounts and certain details on Group Ratio or Equity ratio claims.	Reporting requirements were expected but the Finance Bill contains more details on items which may require reporting in line with the tax return. We expect more specific details on reporting requirements and format of reporting will be issued later in guidance. This reporting obligation will have a real practical impact for taxpayers.

4. Impact on structured finance

- Some key observations from a structured finance perspective:
  - The interest limitation rules could significantly impact S.110 companies who are generally wholly debt financed causing some limitation of the Profit Participating Note ("PPN") interest.
  - The availability of the €3million de minimis threshold on an entity by entity basis offers a measure of relief to S.110 companies. However, we also note that per the Finance Bill, this de minimis operates as a "cliff edge"; where once the exceeding borrowing costs exceed €3million, the entire amount is potentially subject to restriction (not just the excess over €3million as indicated in the second feedback statement).
  - Electing into an "Interest Group" will warrant careful consideration for S.110 companies as the election is generally for 3 years and the "Interest Group" is effectively treated as one taxpayer for the purposes of ILR which may result in only one de minimis exemption for the whole Interest Group in each period.
  - It appears the intention is that intra group transactions within an Interest Group would be effectively ignored for the purposes of calculating any interest restrictions. An Interest Group could include an Irish QIAIF (Qualifying Investor Alternative Investment Fund) established as a corporate (e.g. an ICAV). This may be particularly relevant for example in a S.110 / QIAIF structure. The position is less clear in relation to a unit trust.
  - The "Group of one" may be helpful to S.110 entities that are not a member of a worldwide group, are not in an interest group and not a standalone entity. It allows such entities to access to the Group Ratios even though they are not members of a worldwide Group. This could be helpful to orphan S.110 companies.
  - The inclusion of certain profits or gains on financial assets as interest equivalent is a positive development for S.110 companies investing in debt assets (such as performing and non-perform loans). Further consideration would be required in order to determine what amount of the profit or gain it is reasonable to consider as economically equivalent to interest.

5. Next Steps

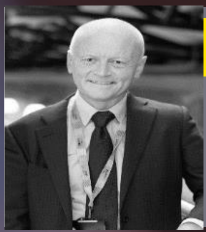
- As noted above, the Finance Bill was published on 21 October 2021. The next stage of the process at which amendments may be tabled is the Committee Stage followed by the Report Stage and the Seanad. It is expected the rules will be signed into law by the end of December.
- As discussed, these rules may have a significant impact for the structured finance sector and progress on implementation of these rules should be closely monitored. Clients should also consider undertaking modeling exercises to better understand the impact of the rules on their business as the implementation progresses.

6. Timeline

- Below is the timeline in relation to implementation of interest limitation rules:

Timeline for transposition	
Finance Bill 2021	Draft legislation – published 21 October 2021
Committee stage	16-18 November
Report stage	30 November – 1 December
Seanad report stage	15 December
President signs Finance Act 2021	Expected by end of December 2021
Rules to take effect	1 January 2022

Contact details



Aidan Walsh
Partner
T: +353 1 221 2578
E: aidan.walsh@ie.ey.com

Petrina Smyth
Partner
T: + 353 1 221 2488
E: petrina.smyth@ie.ey.com

Ciarán Conroy
Director
T: +353 1 221 2591
E: ciaran.conroy@ie.ey.com

Joe Walsh
Manager
T: + 353 1 475 0555
E: joe.walsh1@ie.ey.com

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