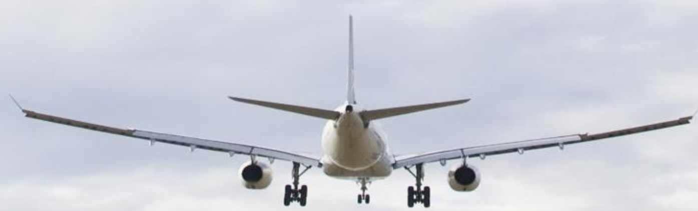
EY - Aviation Finance

Tax Alert

Interest Limitation Rules - Finance Bill 2021

1 November 2021



Building a better working world

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 and 4 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. Impact on aviation finance

- Some key observations from an aviation finance perspective :
  - Aviation finance is a capital-intensive industry and a financing business where profits derived on lease rentals to a large extent depend on a mark up on the cost of funding. Lessors are typically very highly leveraged and therefore the new interest limitation rules have the potential to restrict interest deductions (even relative to other industries) due to the fact that 1) lessors are in a lending business and deploy significant amounts of capital each year and 2) the lease rental returns on operating leases are not classified as interest income (although the Finance Bill provides that a portion of such income be considered "interest" for this purpose - more below).
  - There are several relieving provisions contained in the new rules that will be very welcome to the aircraft leasing industry and could mitigate the impact of the rules, most notably the following:
    - In acknowledgement of submissions made by EY and others on the matter from an aircraft leasing perspective, per the Finance Bill the restricted interest expense will be determined after a portion of the operating lease rental income has been netted against the expense to take account of the implicit interest return on lease rentals over the lease term. Calculated on a lease per lease basis, the interest component is calculated by first computing the net return on the lease over the lease term (after taking account of the accounting measure of depreciation during the lease term) and then applying this percentage to the operating lease accrued in the income statement. Our view is that this one measure could significantly mitigate the impact of the rules for operating lessors.
    - As noted earlier, there is a de minimis threshold introduced that can be applied to every Irish tax payer entity. The amount is €3million per entity and will offer a measure of relief to aircraft lessors. If the net interest expense of an entity does not exceed €3million per annum, then there should be no interest restriction. However, this de minimis threshold operates as a "cliff edge" so once the net interest expense per entity exceeds €3million, the entire amount is potentially subject to restriction (not just the excess over €3million). There is no marginal relief contemplated in the Finance Bill and the first €3million is not always deductible (which it could have been if the cliff edge was not introduced).

3. Impact on aviation finance (Continued)

  - There are generous group relief provisions (Equity Ratio and Group Ratio) for aircraft leasing entities that are part of a large consolidated group of companies and will warrant careful consideration for aviation groups. Both ratios grant relief above the basic 30% EBITDA test.

  - The Equity Ratio will permit an Irish taxpayer entity to disregard the 30% EBITA test altogether in any one year where the equity ratio (i.e. equity/ total assets) of the Irish taxpayer entity is higher than the group ratio or where lower, is not less than 2% lower than the group equity ratio. Alternatively, the Group Ratio will permit an Irish taxpayer entity to compute the allowable amount of interest expense by adopting a percentage rate higher than 30% rate if the group level of third party debt to group EBITDA exceeds the 30% rate, something that might be expected in a highly leveraged business. Both ratios are made available as optional for taxpayers under the Finance Bill. As different lessors will have different underlying capital structures, one may be preferable to the other. There is nothing to prohibit a taxpayer from availing of the Group Ratio in one year and the Equity ratio in another. An election is required to avail of either Group ratio.

- In relation to the Group and Equity ratio tests, an Irish entity needs to identify the Irish or worldwide group into which it will consolidate based on specific provisions in the ILR. This will likely be clear for some groups and much less clear for others. Irish groups that are thinly capitalised (e.g. orphan structures, collective investment structures, ABSs etc) and do not consolidate into a larger worldwide groups must look at the tests at the Irish group level and where there is nominal equity, the group ratio rules are also likely to provide relief from the basic 30% EBITDA test.

- The practical impact of the rules will need to be considered together with new transfer pricing measures on debt capacity, the interaction with the leasing ringfence on capital allowances under s.403 TCA 1997 and the use of losses and loss planning where there are multiple aircraft owning SPVs as is common in the aviation leasing sector. The quantum of debt rules and other Irish interest restrictions rules must be applied first before you assess whether the new ILR will impose a further restriction.

3. Impact on aviation finance (Continued)

- Some other observations from an aviation finance perspective:
  - EBITDA as a measure might not be very reliable for an aircraft leasing company. By way of example, components of revenue such as end of lease compensation payments and maintenance events could drive complexity in examining the impact of the new rules on transactions and introduce uncertainty into cashflow modelling exercises.
  - S.110 entities are not excluded from the interest limitation rules. S.110 companies are often used to own / hold aircraft as "qualifying assets". The interest limitation rules could more significantly impact on S.110 companies as they are wholly debt funded causing some limitation on the profit participating interest and they are taxable at the 25% rate of corporation tax so any restriction will have a greater tax effect. This could be the case where the S.110 company forms part of a larger group with more than nominal equity funding.
  - S.110 companies may continue to be valid in the new environment including S.110 companies that are orphaned or S.110 companies that do not (and are not required to) consolidate into larger groups such as collective investment funds or investment partnerships. This will require a detailed analysis of the consolidation rules contained in the ILR provisions together with accounting rules applying to any stakeholders in the S.110 companies under local GAAP.
  - There is an exemption from ILR with regard to interest expenses on "legacy debt" (i.e. pre 17 June 2016 - see more detail in section 4 below). This may provide some level of relief on older debt structures and could be important for structured vehicles that have a long life and are in place since before 17 June 2016.
  - Interest that is restricted in any one year may be carried forward against future tax periods for up to 5 years. So any entity facing an interest restriction in early years when interest costs are higher could potentially obtain relief in future for some or all of the restricted interest.

4. 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.

4. 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 on financial assets 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 (as noted in section 3 above) and recognises the financing return inherent in leasing businesses – particularly relevant for Irish aircraft lessors. 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.

4. 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.

4. 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 Finance Bill contains 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.

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 aviation 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

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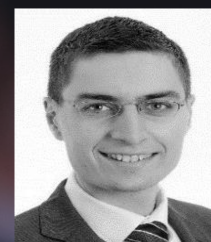

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