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Finance Bill 2016

Changes to section 110 of the Taxes Consolidation Act 1997

BRIEFING

Qualifying companies within the meaning of section 110 of the Taxes Consolidation Act 1997 ("**Section 110 companies**") enjoy tax neutrality, meaning that negligible tax is payable by a Section 110 company to the extent that the income and gains it earns are payable to investors, either as interest on the funding it has obtained or as payments under certain agreements (*eg* Total Return Swaps).

The purpose of this tax regime is to provide a vehicle for securitisation or structured finance transactions that does not give rise to an additional layer of tax. Similar vehicles operate under the laws of other jurisdictions although the Section 110 company is internationally recognised as best in class.

As a Section 110 company must be tax resident in Ireland, the company must be managed and controlled in Ireland. For this reason and because of the expertise that Ireland has gained in servicing and advising Section 110 companies and its stakeholders for almost two decades, many service providers to Section 110 companies are located in Ireland. Accordingly, Ireland gains significant employment from the Section 110 industry.

Section 110 companies are routinely established in Ireland for the purpose of facilitating a number of transaction types with different commercial, regulatory or investment objectives. With particular emphasis on secured loans as an asset class, transaction types commonly undertaken for the past decades include Collateral Loan Obligation transactions ("**CLOs**"), Commercial Mortgage Backed Securitisation transactions ("**CMBS**") and Residential Mortgage Back Securitisation transactions ("**RMBS**").

More recently, however, Section 110 companies have been used for the purpose of investing in portfolios of distressed loans, many of which are secured on Irish real estate. This investment, of course, provided much needed capital to sustain

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the continued existence of such non-performing mortgage loans at that time, while realising cash and alienating the related risk for the seller (in many cases being the original lender or NAMA, as the case may be). This investment also facilitated further time for workout strategies to be agreed with borrowers and/or for borrowers to remedy arrears and/or repay or refinance loans. Nonetheless, due to borrowers' inability to make scheduled payments under these loans combined with the devaluation of the underlying security (being Irish real estate in many cases) and the specialist nature of this non-performing asset class (that therefore attracted limited pools of sophisticated buyers), the market value of these loans was significantly less than the unpaid amount outstanding under the loans at the time of acquisition. Accordingly these loans, as they were worked out, repaid, refinanced and/or sold on, in many cases gave rise to significant gains for Section 110 companies. However, these gains did not give rise to Irish tax for Section 110 companies. This would be consistent with the international taxation approach to such loans in other jurisdictions, whereby they are not regarded as real estate for tax purposes or tax policy purposes.

Nonetheless, as a consequence of consistent political pressure, the Minister for Finance on 6 September last published draft proposed changes to Section 110 which, when enacted, are designed to protect the Irish tax base in relation to income and gains arising in connection with the holding of Irish mortgage loans. In that regard, however, there has been constructive engagement for several weeks so as to refine the draft legislation so as to achieve a targeted solution that will ensure this objective is achieved but without collateral damage to the types of transactions that are not intended to be affected by the proposals.

A further draft is now published as part of the Finance Bill, which albeit significantly refined and much more targeted, will be subject to further amendment as part of the legislative process so as to ensure it operates as intended and has no effect on any investor or asset that is not intended to be affected by the proposal.

Proposal

The Finance Bill proposes that:

- A loan which is secured on and which derives the greater part of its value directly or indirectly from Irish land and certain agreements (*eg* a Total Return Swap) that so derive their value will be specified mortgages.
- Where a Section 110 company is engaged in the business of holding and managing specified mortgages, that part of the business will be a specified property business. However, a specified property business shall not include:
  - a CLO transaction
  - a CMBS transaction
  - a RMBS transaction or
  - (in line with policy to encourage new lending) the business of loan origination.
- A specified property business will be a separate business of a Section 110 company and costs must be apportioned between separate businesses of a Section 110 company on a just and reasonable arm's length basis.
- Unless coming within the exceptions (see below) profit participating interest or interest in excess of an arm's length rate or payments under certain agreements (*eg* a Total Return Swap) paid by a Section 110 company which engages in a specified property business will be treated as a distribution and will not be deductible in calculating the taxable profits of that specified property business, thus giving rise to a corporation tax cost at a rate of 25% for the Section 110 company.

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(continued)

- Exceptions from the above apply to the extent that:
  - the amount represents a return that, when the related security was created, would have represented a reasonable commercial return which is not profit participating for the use of the principal advanced;
  - interest withholding tax at a rate of 20 per cent has been deducted from the payment; or
  - the payment is made to
    - an individual within the charge to Irish income tax or a company within the charge to Irish corporation tax;
    - an Irish pension fund or its EEA equivalent; or
    - an individual that is a national of an EEA state or a company formed under the laws of and registered in an EEA state, where under the laws of an EEA state the interest/payment is subject to a tax which generally applies to income or profits (other than gains) received in that state by persons outside that state. This is further provided that:
      - it is reasonable to consider that the holding of the security that gives rise to the interest/payment by the recipient does not form part of an arrangement, the main purpose or one of the main purposes of which is the avoidance of tax; and
      - the non-resident person (if a company) is carrying on genuine economic activities in an EEA state; and
      - in broad terms, that person is not acting as a tax neutral conduit.
- A Section 110 company will be required to provide to the Revenue Commissioners, within 8 weeks of first acquiring assets, certain details concerning the type of transaction, the assets acquired, the originator, intra-group transactions and connected parties on a new revised Form S110.
- These rules will apply to accounting periods commencing on or after 6 September 2016, with a deemed end of an accounting period occurring on 5 September 2016 for accounting periods not ending on that date.

Going Forward

We expect further amendments during the legislative process so as to ensure that the amended section when enacted operates as intended and has no effect on any investor or asset that is not intended to be affected by the proposal.

McCann FitzGerald

Further information is available from:

Eleanor MacDonagh
Consultant, Tax Group

DDI +353-1-611 9174
EMAIL eleanor.macdonagh@mccannfitzgerald.com

Fergus Gillen
Partner, Head of Finance

DDI +353-1-611 9146
EMAIL fergus.gillen@mccannfitzgerald.com

Hugh Beattie
Partner, Finance

DDI +44-20-7621 1000
EMAIL hugh.beattie@mccannfitzgerald.com

Adrian Farrell
Partner, Finance

DDI +353-1-607 1312
EMAIL adrian.farrell@mccannfitzgerald.com

Alternatively, your usual contact in McCann FitzGerald will be happy to help you further.

This document is for general guidance only and should not be regarded as a substitute for professional advice. Such advice should always be taken before acting on any of the matters discussed.

Principal Office Riverside One, Sir John Rogerson's Quay, Dublin 2, D02 X576
Tel: +353-1-829 0000

London Tower 42, Level 38C, 25 Old Broad Street, London EC2N 1HQ
Tel: +44-20-7621 1000

New York Tower 45, 120 West 45th Street, 19th Floor, New York, NY 10036
Tel: +1-646-952 6001

Brussels 40 Square de Meeûs, 1000 Brussels
Tel: +32-2-740 0370

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Email inquiries@mccannfitzgerald.com **www.mccannfitzgerald.com**