KPMG

Interest Limitation Feedback Statement

Submission to the Department of Finance in respect of the Aviation Finance sector

16 August 2021

Private and confidential
ATAD Implementation – Interest Limitation Feedback Statement
Tax Division
Department of Finance
Government Buildings
Upper Merrion Street
Dublin 2
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16 August 2021

Dear Sir / Madam,

Interest Limitation Rule – Impact on Aviation Finance

Introduction

We are writing in response to the Department of Finance's second Feedback Statement on the implementation of interest restrictions under the EU Anti-Tax Avoidance Directive ("the Directive" or "ATAD"). In the following pages, we provide our responses to the questions put forward in the Feedback Statement regarding the proposed Interest Limitation Rule ("ILR").

Further to our submission of 8 March 2021 in response to the first Feedback statement, we would like to reiterate our view that that Ireland's existing regime, as recently amended with the introduction of comprehensive anti-hybrid rules and updates to Ireland's transfer pricing regime, provides strong protection against base erosion and is already complex for taxpayers to navigate. We support the Department in introducing the ILR legislation as part of Finance Act 2021 but we request that the ILR is implemented in a way that minimizes additional administrative burdens and costs for Irish businesses.

We also fully support the submissions made by Aircraft Leasing Ireland in respect of the ILR and the ongoing dialogue between Aircraft Leasing Ireland, the Department of Finance and Irish Revenue on the implementation of the ILR, as well as the discussions that have happened directly with KPMG.

We noted in our previous submission the specific challenges that aviation finance currently faces that are of relevance when considering the potential impact of the ILR (i.e. the capital intensive nature of the industry; the extremely competitive landscape for attracting investment for this very mobile asset class; the out-sized impact of COVID-19 on the entire aviation sector).

All of these challenges remain and it is therefore critically important that, in implementing Article 4 of ATAD, Ireland allows for as much flexibility and optionality as is permitted within the parameters of ATAD to help support the business case for continued investment in Ireland.

In framing our responses to the questions set out in the Feedback Statement, we have sought to ensure that proposals outlined below are consistent with the requirements of the Directive and also the approach taken by other EU member states.

The legislative references below, unless otherwise specified, are to the Taxes Consolidation Act, 1997.

Key policy recommendations

We outline below our recommendations on the key policy choices that Ireland should make as part of the implementation of the ILR in order to balance its implementation with the needs of taxpayers, including the need for legal certainty and ease of administration.

1. Simplify existing legislative measures limiting the payment and deductibility of interest. This would recognise the significant added protection from base erosion that will arise from the ILR.

2. The implementing legislation for the ILR should make clear that the operation of the ILR should not impose an interest restriction on businesses (such as aircraft leasing) that are economically structured so as to earn a financing return and where those businesses earn a net positive return that is economically equivalent to interest (such as the financing element implicit in a big ticket operating lease).

3. The ILR legislation should not create an additional and disproportionate administrative burden on taxpayers in applying its provisions, for example by requiring novel sets of consolidated accounts to be produced in order to claim the benefit of the group exceptions.

4. The ILR implementation legislation should recognise that Irish taxpayer groups are diverse and should be given flexibility in how their interest groups are structured and operate, subject to fair limitations to prevent abuse of the rules.

5. ATAD provides several options for the implementing legislation. We recommend where these options arise, the legislation should provide taxpayers with a choice on an elective basis. This approach would recognise the diverse nature of businesses operating in Ireland and the inherent limitations that can arise for both pre-existing and future financing structures.

Question 2: ***Comments are invited on these possible definitions of 'relevant entity' and 'interest group' and, in particular, how the possible definition of an 'interest group' interacts with the group ratio rules.***

Definition of interest group

We request that the definition of interest group be amended so as to include any company that is both:

(i) included in the ultimate consolidated financial statements of the group; and
(ii) liable to corporation tax in Ireland.

This approach would align the interest group concept with the wider provisions of ATAD which apply with reference to the consolidated accounting group. It would also provide flexibility to taxpayers to aggregate their Irish accounting group's ILR positions without arbitrary breaks in group membership that may be caused by ownership structures.

We believe that this approach is justified by the accounting group emphasis of many of the ILR provisions. It would be a strange result if two separate Irish Section 411 tax groups with the same ultimate parent were to compare their results to those of the worldwide accounting group (inclusive of the other Irish Section 411 tax group) under the Equity Rule and Group Ratio Rule without the opportunity to combine the Irish operations into a single interest group.

In order to protect from the risk that the above approach could change the operation of the Irish tax losses rules, a protective provision could also be included to ensure that to the extent the disallowable amount is to be carried forward effectively as a tax loss, that tax loss may only be shared between companies that would otherwise form a Section 411 tax losses group.

Group election

We welcome the definition of group that facilitates members opting out of the group on an election basis, thereby not making group membership mandatory.

To retain the flexibility of groups to organise their tax affairs in accordance with their business operations, a taxpayer group should retain the ability to choose which companies within the group form an interest group for the purposes of the ILR and a taxpayer group should be permitted to form two (or more) interest groups at the choice of the taxpayer entities, subject to the proviso that no company can have membership in more than one group at the same time.

This capacity for flexibility on the make-up of an interest group is particularly important in the aviation finance sector, as many Irish lessors may be part of wider corporate groups with diverse activities.

For example, some larger corporate groups may have two or more independently run businesses / divisions that are operationally separate but may share a common parent. For tax loss group purposes, the business divisions can, from a practical perspective, be kept separate but this would not be possible for ILR purposes as the grouping provisions as drafted are automatic and it may result in the aggregation of business division activities that are separate for operational purposes.

It would also be administratively burdensome for taxpayers to combine the results from these business divisions. Therefore, while we advocate a wider definition of interest group (as set out above), it is important for taxpayers that they are able to make reasonable choices as to how their interest group(s) are constituted given the automatic operative mechanics of the grouping mechanism as proposed.

In addition to the practical consideration above, being able to keep certain group companies separate from the wider group can also be important from an aviation finance (and wider financial services) perspective in situations where there are financing covenants that require the separateness (from a corporate perspective) of borrower entities to be maintained.

The alternative in practice for many groups, if separate interest groups are not permitted, will be for company-by-company elections to be made to keep entities out of the wider interest group. However, this would cause significant practical issues and an incremental compliance burden for taxpayers as both interest group and company-by-company calculations would be required.

We do not believe that Article 4(1) imposes a requirement on Member States to have only a single interest group.

Question 4: ***Comments are invited on the exclusion for financial undertakings generally and this possible definition of 'financial undertaking'.***

Article 4(7) of ATAD1 provides that Member States may exclude financial undertakings from the scope of the ILR, including where such financial undertakings are part of a consolidated group for financial accounting purposes. We propose that the ILR legislation provides taxpayers with the option to exclude financial undertakings from the scope of the ILR.

This point is particularly important for many aviation finance businesses that may be owned by banks or other financially regulated entities. From a practical perspective, it may be extremely difficult for such financial undertakings (e.g. the group parent or a material group subsidiary) to be extracted from the group accounts and/or the Irish lessor subsidiary may not have the ability to re-calculate the group results excluding such entities. Therefore, a mandatory exclusion of financial undertakings may render the group exceptions unusable for Irish lessors.

If it is felt that the Directive does not allow a Member State to provide this option to taxpayers, we recommend that Ireland does not exclude financial undertakings from the scope of the interest limitation rule.

We would also note that other countries with large internationally focussed financial services industries such as Germany, the UK and Luxembourg have not excluded financial undertakings from the scope of the ILR.

Question 5: ***Comments are invited on this possible definition of 'legacy debt' and more generally on the concept of a modification in the context of legacy debt. Comments are invited on how this drafting would apply in respect of drawdowns on revolving credit facilities and phased drawdowns of loans under existing debt agreements.***

We welcome the introduction of the legacy debt exemption as provided for in the Directive.

In line with the view expressed on the public ILR video conference with the Department of Finance on 19 July 2021, we suggest that the legislation or supporting guidance make clear that debt will qualify as legacy debt for the purposes of the ILR where the terms of that debt were agreed on 17 June 2016, even where the principal on that debt was drawn down after that date (but in accordance with the terms as agreed on or before 17 June 2016).

We also propose that provided the terms of the debt have not been amended so as to (i) extend the maturity, (ii) extend the available principal, or (iii) increase the interest rate (i.e. material amendments that may increase the interest deductible beyond the terms as agreed on 17 June 2016), the debt

should retain its legacy status even where there may be repayments and/or further drawdowns. This could be applicable, for example, for certain types of "revolving" credit facilities where the facility may allow drawdowns and repayments.

We also suggest that the clarification by the Department of Finance in the first consultation document that a loan entered into before 17 June 2016 would not be regarded as having been modified, and the ILR would not apply, in circumstances where, as a result of benchmark reform and/or withdrawal, it is necessary to replace the reference rate on the loan with a comparable benchmark (e.g. due to LIBOR being phased out) is set out in implementing guidance, to ease the administrative burden on taxpayers from such reforms.

Question 8: ***Comments are invited on these possible definitions of 'interest equivalent', 'taxable interest equivalent' and 'deductible interest equivalent'.***

Following on from our previous submission and our discussions with you since that submission, in defining "interest equivalent", we believe that the following should be considered:

a) The leasing of aircraft and similar aviation assets (e.g. engines) is fundamentally a financing business, whereby the profitability of the business is dictated by the excess of the interest return implicit in a lease over the cost of funding that asset (i.e. the cost of capital invested in the asset). For this reason, "interest equivalent" should include the implicit interest element of aviation operating lease payments.

b) The profits of a securitisation company should be treated as interest income so as to preserve the integrity of the cash flows available to the company to service the debt secured on its assets and to preserve the legislative intention that such entities should be tax neutral.

c) Amounts booked to the profit and loss account that are related to fluctuations in or revaluations of the principal component of debt should be excluded from being considered an amount that is "economically equivalent to interest".

Operating leases

In relation to (a) above, we refer to our more detailed comments in our previous submission and the subsequent and detailed submissions made by Aircraft Leasing Ireland on this point, to which we have contributed and that we fully support.

For completeness, we have also set out in Appendix I some suggestions in relation to how this concept could be captured either from a legislative perspective or through supporting guidance.

Securitisation companies

In relation to (b) above, where securitisation companies have issued debt to third parties, they do not present a significant risk of base erosion due to interest deductions, as they are merely the vehicle through which the cash flows used to fund the qualifying asset pass between the third party debt holders and the originator of the qualifying assets held by the securitisation company.

We suggest that the profits of the securitisation company should be treated as interest income under the ILR. This is subject to adjusting this profit by the amount of any operating costs such as management fees deducted in arriving at the net taxable profit of the company. This treatment is purely for the purposes of the ILR and is not suggested to replace or supersede other limitations on deductions that might apply under section 110, TCA 1997 in measuring the taxable profits of the company for the period. This approach would acknowledge the legislative intention that such entities would be tax neutral.

In the absence of this recommendation being implemented, we note that Finance Act 2007 specifically expanded the definition of "qualifying asset" for the purposes of Section 110 to include plant and machinery, thereby allowing securitisation companies to hold leased aircraft and other assets. The implementation of the ILR will disproportionately impact leasing groups who have utilised Section 110 entities to hold aircraft. Provision should therefore be made for a loss transition mechanism for companies electing out of the Section 110 regime, such that any Case III losses can be carried forward as Case I losses.

A further option in this scenario is that, for tax purposes, there could be a deemed market value disposal of the aircraft occurring on the election out of the Section 110 regime. Such an approach would be helpful in ensuring that tax losses carried forward (primarily relating to capital allowances on the aircraft) would not be unfairly foregone.

Movements related to debt principal

In relation to (c) above, we suggest that it be made clear in the implementing legislation (or supporting guidance) that certain movements through a taxpayer's profit and loss account related specifically to debt principal should be excluded from being considered an amount "economically equivalent to interest". For example:

(i) *Fair value movements on financial assets and liabilities*

Fair value movements on financial assets and liabilities may have links to interest rates but would not seem generally to represent gains or losses that are economically equivalent to interest from the borrower's perspective. Such fair value movements can generally only be realised by the lender as a gain or loss upon sale of the debt. We suggest therefore that fair value movements on financial assets or liabilities are expressly excluded from the scope of the definition of 'interest equivalent'.

(ii) *Bad debt impairment*

Impairment losses on bad debts do not appear to be equivalent to interest. Provisions for impairment of bad debts (including loans) do not fall within the three categories of expense listed in ATAD1 within the scope of the ILR. We suggest that impairments should not be included in the definition of borrowing costs on the basis that such losses do not appear to be economically equivalent to interest.

Question 11: ***Comments are invited on the above approach to the transposition of the equity ratio rule.***

In order to give certainty to taxpayers, we request that the definition of "equity" refer to the classes of equity in the relevant company's financial statements (e.g. including retained earnings, non-Irish equivalents to share capital, share premium, etc.). We believe that this is particularly important given the requirement to refer to the ultimate consolidated financial statements, which may be prepared under an alternative body of accounting standards. It would represent a disproportionate burden on Irish groups if any adjustment were required to the measure of equity in the ultimate consolidated financial statements prior to applying the equity ratio rule.

In relation to the practical application of the equity ratio rule and as outlined in more detail on Question 19 below, most Irish groups that have international operations or subsidiaries (or that are part of larger worldwide groups) do not prepare consolidated accounts consisting solely of the Irish group members. Therefore, the calculations for the group ratios should take this into consideration.

As Ireland-only consolidated accounts will typically not exist, the calculation for the Equity Rule (and Group Ratio Rule) should be capable of being done using an "aggregation approach" based on all the single entity financial statements in the Irish interest group. Taking this approach would align with how

most groups already calculate their group tax provisions and would be administratively more straightforward and efficient to administer for taxpayers.

We understand that there is a concern that asymmetry of treatment for intragroup transactions between group members may result in an "aggregation approach" giving rise to anomalies (e.g. a deductible expense in one company and capital / non-taxable treatment in another). In practice, such asymmetry is very unlikely to give rise to a favourable result for a taxpayer. For example, it would be unlikely that an expense would be deductible as a trading expense in one group company and not taxable as a capital receipt in another – in the absence of "trading" treatment for the receipt, it is more likely that the receipt could be taxed as passive income at a higher 25% tax rate.

Question 16: ***Comments are invited on the proposed interaction of the interest limitation rule with the balance of the corporation tax code.***

The calculation of an interest limitation restriction is to be done after the application of all other reliefs. However, where the interest limitation rule applies, this may give rise to additional taxable profits which might be capable of being sheltered with reliefs which would not have been used or claimed had the restriction not applied.

This possibility is specifically contemplated in the consultation and is the case for the two categories of carried forward disallowable amount set out in Section 3.9. As a result, we recommend that it is made clear that any available reliefs (such as loss relief, charge relief and group relief) can be applied against the additional taxable income arising from the restriction.

We agree with the approach that targeted interest expense provisions contained in the Taxes Consolidation Act are applied in priority to the interest limitation rule. Specifically, clarification in legislation that transfer pricing adjustments to interest income / interest expense are applied in priority to the restriction would be welcome.

Question 19: ***Comments are invited on this potential approach to applying the ILR to interest groups. In particular, it is noted that the provision would require reference to accounts that comprise the results of all group members. Comments are invited on the most effective method for compiling such accounts, noting that disregarding transactions between members of an interest group may be complex and administratively difficult for some groups. Stakeholders are invited to suggest how this process may be simplified.***

Reporting entity

We agree with the practical approach taken that allows for a group to have a single entity reporting information to Revenue and allocating amounts to the respective group members.

However, we recommend that the interest group should be free to pick the reporting entity within the interest group. It would be common for large groups (including aviation finance groups) to centralise their tax, finance and operational functions into one group company which may or may not be the top "parent" entity. Allowing the interest group to choose the reporting entity will provide flexibility to businesses to organise its tax compliance obligations in line with its current practices.

Eliminating intragroup transactions

We request that Irish groups be permitted to aggregate their results (an "aggregation approach") in compiling the accounts required for applying the ILR to the interest group.

Subsection (3)(a) appears to suggest that in completing its calculation under ILR, the reporting entity would use the results of all of the group entities but modified so as to disregard all intra-group transactions. We consider such an approach (a "consolidation approach") would impose a very substantial burden on taxpayers.

The Irish corporation tax regime does not currently provide for tax liabilities to be calculated on a consolidated basis. Each company in a corporate tax loss group is required to firstly determine its own taxable profits and subsequently, can surrender loss relief to other members of the group. Consequently, preparing group tax adjusted consolidated amounts for this single purpose (i.e. the ILR) would be a fundamental divergence from how the Irish tax system works.

Apart from imposing a significant burden on taxpayers to identify each and every intra-group transaction within the Irish group and adjusting for these transactions (for the purposes of this ILR tax consolidation), the companies themselves will continue to be taxed on a non-consolidated basis for all other purposes.

It is unlikely that the existing financial statements of Irish groups could be used for this purpose, either because: (i) they simply do not exist (see previous comments above), or (ii) the Irish group financial statements include entities which are not part of the ILR group (i.e. companies outside an interest group or non-Irish tax resident companies). Therefore, a new standalone set of tax consolidated accounts would need to be prepared for the purposes of the ILR. This would be a significant undertaking for Irish groups.

Taking an "aggregation approach" would align with how most groups already calculate their group tax provisions and would be administratively much more straightforward and efficient to administer for taxpayers.

We understand that there is a concern that asymmetry of treatment for intragroup transactions between group members may result in an "aggregation approach" giving rise to anomalies (e.g. a deductible expense in one company and capital/non-taxable treatment in another). Firstly, asymmetry is an inherent feature of the Irish tax system due to the three rates of tax applicable to Irish companies (12.5%, 25% and an effective rate of 33%). Therefore, perfect symmetry is not something that the Irish tax system typically considers as a prerequisite. The Irish tax system also already contains targeted anti-avoidance to counteract certain instances of asymmetry of tax treatment (e.g. Section 817C) and these rules should provide adequate protection to the Irish Exchequer.

Furthermore, in practice, such asymmetry is very unlikely to give rise to a favourable result for a taxpayer. For example, it would be unlikely that an expense would be deductible as a trading expense in one group company and not taxed as a "capital" receipt in another – in the absence of "trading" treatment for the receipt, it is more likely that the receipt could be taxed as passive income at the higher 25% rate.

In summary, layering an interest limitation rule on top of the pre-existing targeted interest measures necessitates an interest limitation rule that does not apply an unnecessary compliance burden on the taxpayer. Ireland should take comfort in the targeted provisions that already exist to protect the Exchequer from base erosive asymmetric taxation of payments.

As a result, we recommend this subsection is removed from the ILR and is either replaced with a subsection that states that in applying each of the calculations set out in the various steps, they are to be done by aggregating each of the relevant measurements, components, or amounts for each of the group members or that the underlying provisions are modified to achieve this effect.

Question 21: ***Suggestions are invited concerning appropriate adjustments to the preliminary tax rules, to allow reasonable opportunity for compliance with preliminary tax obligations following the introduction of the ILR.***

In acknowledgement of complexity of the ILR and time it will take to amend technology to implement the ILR, we recommend that Revenue provide a waiver for interest chargeable on an underpayment of preliminary tax arising from the ILR for 2022 and 2023. This could be implemented by way of guidance in line with Revenue's practice[1] of waiving interest charges where a company fails to comply with preliminary tax obligations due solely to a fluctuation in currency exchange rates.

Question 22: ***Comments are invited on these possible reporting requirements with regard to the ILR.***

Question 23: ***Comments are invited on these possible reporting requirements with regard to the ILR.***

The details to be included in a corporate tax return must balance the compliance burden incurred by the taxpayer with the necessity for Revenue to collate the information to ensure compliance with the regime. Over the last several years, as corporation tax rules have increased in complexity, the CT1 Form has grown in length requiring the provision of substantially more information from the taxpayer. Taxpayers are also required to submit tagged iXBRL accounts, form 46Gs and country-by-country reports to name but a few.

We propose that the reporting requirements proposed for both single entity and group reporting be re-considered so as to lessen the compliance burden (and cost) on Irish taxpayers as much as possible while providing Revenue with the targeted and key information metrics required to ensure the proper functioning of the tax system. We do not believe that the operation of the ILR mandates a wholesale reporting requirement of various data to Revenue to ensure it functions properly.

* * * *

We welcome the engagement that the Department of Finance and Revenue have shown to date on the ILR. We hope the above highlights the importance of this issue to the aviation finance sector. Our recommendations are in keeping with the spirit of the Directive and they are aimed at helping the sector navigate a complicated and important issue, at a time of great challenge and uncertainty.

We would welcome an opportunity to discuss the above with you. In the meantime, if you have any questions or comments, please do not hesitate to contact us.

Yours faithfully,

Joe O'Mara
Partner, Head of Aviation Finance

[1] Part 41A-07-01 - Underpayment of Preliminary Corporation Tax (revenue.ie)

Appendix I

Operating lease to include an amount that is "economically equivalent to interest"

As outlined above and in our previous submissions, we believe that there is a clear and robust case to support the position that operating lease rentals earned by a lessor in respect of "big ticket" or long-term assets should be viewed as containing a return that is "economically equivalent to interest".

Referring to Question 8 of the consultation, we suggest that this position can be captured either by amending the currently proposed definition of "interest equivalent" or through supporting guidance. We have outlined each proposal below.

Legislative approach

We believe that the current definition of "interest equivalent" as included in Section 3.4.1 of the ILR consultation could accommodate the above principles through the following change:

> ***interest equivalent**' includes any amount of —*
>
> a) *interest,*
>
> b) *amounts economically equivalent to interest including -*
>
> *(i) discounts,*
>
> *(ii) the finance cost element of finance lease payments,*
>
> *(iii) the amount economically equivalent to interest that is implicit in an operating lease rental earned by a company that is engaged in a trade of leasing of plant or machinery,*
>
> *(iv) amounts under derivative instruments or hedging arrangements connected with the raising of finance,*
>
> *(v) foreign exchange gains and losses related to interest on instruments connected with the raising of finance,*
>
> c) *amounts in connection with raising finance, including -*
>
> *(i) guarantee fees, and*
>
> *(ii) arrangement fees, and*
>
> *shall also include any amount arising from an arrangement, or part of an arrangement, which could reasonably be considered, when the arrangement is considered in the whole, to be economically equivalent to interest*

Guidance approach

The preferred approach to give certainty to taxpayers would be to include in legislation a clear reference to the principle that the financing return implicit in an operating lease rental should be considered an amount "economically equivalent to interest".

Where this is not feasible (or in combination with the proposed legislative approach), we would ask that guidance be issued to provide clarity and certainty as to the circumstances in which an amount economically equivalent to interest is recognised for operating lessors.

It would also be preferable to provide guidance around how the amount of operating lease rentals that is "economically equivalent to interest" should be calculated.

<u>Recognition of amount that is "economically equivalent to interest"</u>

If our suggested addition to the definition of "interest equivalent" as outlined above is not incorporated in the final ILR legislation, we also propose that the future ILR Tax & Duty Manual should provide

clarity to taxpayers on the circumstances in which operating lease rentals should be considered to have a component that is "economically equivalent to interest" and therefore fall within the catch all provision in the definition of interest equivalent. We have proposed some sample guidance below.

> *Where (i) a company undertakes a trade of leasing (as defined in Section 403 TCA 1997) and is taxed on the profit arising from this trade in accordance with Schedule D Case I or (ii) a company is taxable under Schedule D Case III in accordance with Section 110 TCA 1997 and holds plant and machinery as its qualifying asset (each hereafter a "Lessor"), Revenue are prepared to accept that a portion of the income earned by such a Lessor pursuant to an operating lease may be considered to constitute an "amount arising from an arrangement, or part of an arrangement, which could reasonably be considered, when the arrangement is considered in the whole, to be economically equivalent to interest."*
>
> *The burden shall be on the Lessor to demonstrate that it is reasonable to conclude that a portion of the operating lease rentals should be considered economically equivalent to interest.*
>
> *Any such assessment shall be made having regard to all the relevant facts and circumstances related to such operating lease, but the following factors may be indicative of such treatment:*
>
> i. *The company falls within the definition of Lessor as stated above; and*
>
> ii. *The Lessor should commercially evaluate the operating lease transaction with reference to earning a financing return and should be able to evidence this as required; or*
>
> iii. *The operating lease has been drafted on the basis that the operating lease rentals are calculated on a similar basis as the return on a loan (e.g. floating rate rental set with reference to an external interest rate benchmark such as LIBOR, etc.); or*
>
> iv. *The nature of the underlying asset is such that the lessor is effectively providing long-term finance to fund the lessee's use of the asset.*