ATAD Implementation – Interest Limitation Feedback Statement
Tax Division
Department of Finance
Government Buildings
Upper Merrion Street
Dublin 2, D02 R583
By email: ctreview@finance.gov.ie

16 August 2021

Dear Sir or Madam

Re. ATAD Implementation Article 4 Interest Limitation - Feedback Statement

The Irish Debt Securities Association ("**IDSA**") welcomes the opportunity to reply to the Second Feedback Statement of July 2021 on the ATAD Interest Limitation Rule ("**ILR**"). This reply builds upon and further develops our submission to, and our subsequent engagement following, the First Feedback Statement of December 2020 and the November 2018 public consultation on the implementation of the ATAD Anti-Hybrid rules and ILR and we welcome the opportunity to make this further contribution.

During our continued engagement, previous responses and submissions, we have noted the membership, role, and objectives of IDSA, the significance and opportunity of structured finance, debt securities and the specialist securities industries as pillars of the EU Capital Markets Union and as a critically important sector to facilitate the raising of finance by banks, companies, governmental agencies and business generally in the European Union particularly given the challenges of the COVID-19 pandemic. We also note the leading position of Ireland in this sector in the European Union and internationally. In this respect, the implementation of ATAD and, in particular, the introduction of the ILR is of critical concern to the securitisation sector specifically, but also the international financial services sectors in Ireland generally as the sector's legislative framework supports and underpins the other main international financial services sectors in Ireland including aircraft leasing, investment funds and reinsurance by enabling companies in these sectors to establish financing companies and manage risk appropriately.

When replying to the initial public consultation, the First Feedback Statement on the Interest Limitation Rule and the continuing engagement, we have highlighted the importance and complexity of the issues being considered and as such we welcome the Second Feedback Statement and this further consultation on these very important issues. However, the complexity of the issues is still a very real consideration, and we note and welcome the proposal in the Second Feedback Statement that as part of the consultation, the Department may meet with stakeholders in advance of the introduction of the ILR in Finance Bill 2021 and we encourage and look forward to this continuing engagement.

Below follows our input on and response to the Second Feedback Statement and we would welcome the opportunity to meet with the Department and the Revenue Commissioners immediately following this consultation period to highlight and work through the practical challenges arising, which we believe will assist in the consideration and support the preparation of the ILR for introduction in Finance Bill 2021.

Yours faithfully

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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.

The interest group should be treated as a single 'taxpayer' as contemplated in section 3.1 of the Second Feedback Statement for the purposes of the group ratio rules with consolidation determining whether the interest group would be treated as a 'group of one' ('single company worldwide group'), or could apply the standard group ratio rules. Thus, if there is no consolidation as between the interest group or any member in the interest group, and any entity outside the interest group, the interest group would be treated as a 'group of one'. However, if there is consolidation as between any company within the interest group and an entity outside the interest group, then the interest group should have the option to apply the standard group ratio rules, with the equity ratio rule and the group ratio rule applying on the basis of the results of the wider consolidated group as a whole. Our comments in this regard should equally apply with respect to Question 12.

Moreover, in paragraph 3(g) of section 4.1 it states that "*where the interest group does not prepare consolidated financial statements under generally accepted accounting practice or an alternative body of accounting standards, section XXX [Equity ratio rule] shall apply to the consolidated financial statements which would be prepared under generally accepted accounting practice, if such accounts were required to be prepared.*" We consider that the group ratio rule should also apply to this situation and therefore to the consolidated financial statements which would be prepared under GAAP. This would be consistent with the rest of the Second Feedback Statement and we see no reason why the group ratio rule should be excluded.

Question 3

Comments are invited on these possible definitions of 'standalone entity', 'associated enterprise', 'enterprise' and 'entity'.

It is acknowledged and accepted in section 3.6.3 of the Second Feedback Statement that "*a company with one shareholder owning 25% or more of the shares is not a 'standalone entity', notwithstanding that this may be a single small owner-operated company, because the definition of an 'associated enterprise' includes any individual who owns at least 25% of the entity. The ILR restricts all interest, including third-party interest, so this could result in a company with no real group associations being subject to an ILR restriction on genuine interest expenses, purely because it has one large shareholder.*"

The Second Feedback Statement goes on to note that other Member States have dealt with this unusual outcome in a number of ways, from excluding certain shareholdings when determining associated entities (which carries an avoidance risk), to providing for a "group of one".

While we support the concept of a "group of one" provided for in section 3.6.3 of the Second Feedback Statement and are of the view that this is necessary as a legal matter, we still consider that the concept of "standalone entity" could and should be applied to a securitisation company as explained below.

Standalone entity

A typical securitisation company will have nominal issued share capital (often €1 only) held by a share trustee company which is administered by a corporate services provider. The securitisation company will issue bonds to investors. The issued shares will have nominal economic value (but must exist for company law purposes) and the trustee will typically hold the shares on trust under a "purpose trust". This purpose trust does not have identifiable beneficiaries during the life of the trust and the transaction and is often described as an "orphan trust". In Ireland, the purpose trust will typically be established with general charitable objects. Certain other jurisdictions where securitisation companies are established have dedicated "purpose trust legislation".

The result of these arrangements is that the securitisation company has no beneficial or economic owner of the shares and consequently is described as "bankruptcy remote" from any other person. These arrangements are commercially and legally required by stakeholders such as bondholders, rating agencies and commercial lenders. The result is that, from an economic and insolvency perspective, the securitisation company is not part of a larger group.

The shares of the securitisation company are 100% legally held by in the name of the trustee company on trust. The trustee company is neither the beneficial nor economic owner of the shares. The key question is whether the securitisation company in this case can be regarded as a standalone entity or rather is considered to have an “associated enterprise” being the trustee company. We are assuming for the purposes of this analysis that none of the bondholders are an associated enterprise and are not consolidated for accounting purposes with the securitisation company, so the securitisation company is not part of a worldwide group, and that the securitisation company has no permanent establishment or subsidiaries. For completeness, the securitisation company would not be consolidated for accounting purposes with the trustee company.

In our view, the securitisation company should be regarded in those circumstances as a "standalone entity" and that this is entirely consistent with the ATAD Directive and OECD BEPS Action Plan for the following reason ('Analysis' below). We are also of the view that the relief for a "standalone entity" must be capable of being utilised under the ATAD Directive for a widely held company such as a securitisation company in this case and that this was the intention when the ATAD Directive was drafted and agreed and that the relief cannot have been intended to be redundant and incapable of effective application.

Analysis

The trustee company in its own right should not be regarded as an “associated enterprise” of the securitisation company because it does not hold its shares beneficially nor can it exercise voting rights in respect of the shares on its own behalf. Instead, it holds the shares and associated voting rights on behalf of a trust with charitable objects, being a purpose trust.

The "associated enterprise" test must therefore be applied to the trust, not to the trustee company in its own right. In this regard, consistent with existing Irish tax legislation, the legislation implementing ILR into Irish law must have regard to the principles of trust law in the Irish common law system and apply taxation and reliefs on the basis of a "beneficial ownership" test rather than a "legal ownership test".

This position is reflected, for example, in the "group definitions" in sections 9 and 411 TCA where there is reference to ownership being beneficial ownership. This is also reflected in the fact that the "trustee company" would not appear to form an "interest group" with the securitisation company given that the definition makes reference to the test in s.411.

We would propose that this is reflected in the proposed definition of "standalone entity" in the First Feedback Statement as follows:

Applying the "associated enterprise" test to the trust, the trust is not an “associated enterprise” because it is not an "entity" on the basis it does not have "legal personality" (application of the test in s.835Z TCA), and we would request that this is reflected in guidance to the legislation when published.

<u>Question 5</u>

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.

Article 4(4) of the Directive provides that Member States may exclude from the scope of ILR exceeding borrowing costs incurred on loans which were concluded before 17 June 2016, but the exclusion shall not extend to any subsequent modification of such loans. The preamble notes at paragraph 8 that “Member States could provide for a grandfathering clause that would cover existing loans to the extent that their terms are not subsequently modified i.e. in case of a subsequent modification, the grandfathering would not apply to any increase in the amount or duration of the loan but would be limited to the original terms of the loan”.

In this regard, we welcome the revised definition of legacy debt included in the Second Feedback Statement, with the removal of the specific Section 135(8) TCA 1997 definition simplifying matters of interpretation. We also welcome the updated approach to the calculation of the “amount in respect of legacy debt” which may be excluded from the calculation of exceeding borrowing costs.

Legacy debt is defined in the Second Feedback Statement as meaning “a debt the terms of which were agreed before 17 June 2016”. We assume this is referring to the material terms of a loan which existed on 16 June 2016: material terms meaning the amount of **principal** that has been or can be drawn down under the loan, the **reference rate** by which the interest payable under the loan is calculated and the **duration** of the loan. Technical and other changes which do not impact on the interest payable under the loan should not constitute modifications and nor should mechanical changes in the interest rate which are already catered for or contemplated in the loan agreement. We also consider that the "terms of which were agreed" should refer to legally binding obligations.

Other tax authorities have issued guidance on what would or would not constitute modifications in the context of the ILR rules and we would strongly advocate that the Revenue Commissioners do likewise. Thus for instance changes to the quantum of the loan, its duration and/or the interest payable on the loan which were not provided for or contemplated in the agreement in place on 16 June 2016 would constitute modifications, and grandfathering provisions would only apply on the basis of the legacy terms. However, the following changes would not constitute modifications:

- Drawdowns after 16 June 2016 under a facility in place on that date;
- Changes to the quantum, duration and interest payable under the loan which were contemplated or automatically provided for under the legacy agreement;
- Changes to the frequency of interest payments, or principal repayments under the loan;
- Changes to the guarantee arrangements under the loan;
- Technical or administrative changes which do not impact the interest payable under the loan;
- Assignments of the loan where the terms and conditions remain the same.

Phased drawdowns under loans and facilities in existence on 16 June 2016 would clearly not constitute a modification under the above principles. Thus drawdowns under Profit Participating Notes or Profit Participating Loans, up to the agreed amount of facility in place at 16 June 2016 and typically providing for interest payable of an amount equal to the annual taxable or accounting profits of the company, would be grandfathered. The position is not as clear cut for Revolving Credit Facilities (RCFs) where credit is made available up to a limit for specified periods but where ongoing repayments and readvances (but always within the limits of that facility) are typical. It would be unfair to discriminate between credit facilities provided for under a phased draw down loan facility and a revolver facility in such a fundamental manner particularly as no opportunity was given to companies back in 2016 to restructure their funding arrangements. We understand that concerns arise that allowing such an approach for RCFs may enable taxpayers to rely on the legacy debt exemption for extended, and in some cases, indefinite periods of time. To allay any such concerns we would suggest that a provision of say 12 years* from 16 June 2016, would apply such that the legacy debt exclusion could not be availed of beyond that date.

There are many different types of credit arrangements in place apart from the loan facilities and RCFs referred to in the Second Feedback Statement but we believe acknowledgement of the principles above will give taxpayers and the Revenue Commissioners a basis to determine whether, or to what extent, the legacy debt exclusion should apply to any specific set of facts and circumstances.

- *For a variety of purposes Revenue Commissioners consider that the borrowings may be regarded as revenue in nature where the life of the debt is 12 years or less.*

Question 8

Comments are invited on these possible definitions of "interest equivalent", "taxable interest", and "deductible interest equivalent".

In our responses to the First Feedback Statement, we set out our views on the possible definition of interest equivalent and our concerns in respect of the narrow definition potentially being proposed for the legislation when compared to the definition contained in ATAD itself.

We have considered the proposed definition contained in the Second Feedback Statement and, while we believe that this covers a considerable number of the interest equivalent types of income and expense that we were concerned with, we do believe that there are a number of areas where there is still doubt as to whether the relevant income or expense would be considered interest equivalent which we feel needs to be addressed in advance of the implementation of the provisions.

Some of these issues may be more appropriately dealt with in guidance by way of examples, rather than specifically being addressed in the legislation, but in this regard, it is of critical importance that where these issues are to be dealt with in guidance that this is developed contemporaneously with the legislation, such that there is a degree of certainty for taxpayers at or around the time of the relevant introduction of the legislation in the definition of interest. We believe that otherwise there would be a "gap" between the traditional Irish / common law definition of "interest" and the wide definition of "interest" (or "borrowing cost") in the ATAD Directive. In this regard, the definition of "interest equivalent" itself is in part interpreted by reference to "interest", so it is vital that "interest" has the full meaning provided for in the ATAD Directive and not potentially a narrower traditional Irish legal meaning.

We consider that the following, listed in the definition of "borrowing costs" in the ATAD Directive, should be specifically referenced in the Irish legislation to the extent not already included: "*payments under profit participating loans, imputed interest on instruments such as convertible bonds and zero coupon bonds, amounts under alternative financing arrangements, such as Islamic finance, the finance cost element of finance lease payments, capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest, amounts measured by reference to a funding return under transfer pricing rules where applicable, notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings, certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance, guarantee fees for financing arrangements, arrangement fees and similar costs related to the borrowing of funds*".

One area of concern is the treatment of discounts generally. While we note that the proposed definition refers to discounts, it is unclear as to how broad that term is or will be interpreted. For example, will a distinction be drawn between original issue discount at which an instrument might be issued by an issuer on the one hand, and a discount to par at which an instrument or loan might be acquired at in a secondary trade? In each case, our view is the discount is economically equivalent to interest.

We welcome the inclusion of "amounts economically equivalent to interest including discount" however, confirmation that gains and losses on loan portfolios (including non-performing loans ("**NPLs**")) and fair value movements on all forms of debt would be viewed as included as "interest equivalent" would be helpful for credit investments. This would align with the treatment adopted in the United Kingdom whereby gains and losses on loan portfolios is regarded as interest for the purpose of the interest limitation rules, under their loan relationship rules. It would be beneficial to provide clarity to taxpayers through expressly providing for this in legislation. If not possible to provide for this in legislation, it should be clarified in guidance released soon thereafter to avoid uncertainty in the market.

To the extent that a portion of the profit realised on the NPLs is not equivalent to interest, then the apportionment between the gain and interest element should be done on a just and reasonable basis. In this regard, it would be helpful and consistent to consider how other EU Member States have implemented this rule. We understand that the Luxembourg Tax Authorities accept that the profit element of a non-performing loan can be allocated between interest income and non-interest income based on the "interest" amount included in the audited financial statements. This apportionment is allocated based on IFRS 9 whereby the interest amount included in the financial statements is based on the rate that discounts estimated future cash flows through the expected life of the financial asset. Allowing for such a method of apportionment for profit attributable to NPLs would provide clarity to taxpayers and would align with the interest amounts treated as such in the audited financial statements of the taxpayer. We also understand that the same method of apportionment is used in Sweden.

We also note that the German Tax Authorities have released guidance that any gains triggered from the sale of non-performing loans should not be regarded as interest for the purposes of the German interest limitation rule. However, the parties to the agreement may jointly file and elect to treat the sale of a non-performing loans as a true third party lending transaction, which would then result in the return being treated as interest within the scope of the German interest limitation rules.

We also believe that there needs to be additional clarity in respect of the treatment of a range of transactions commonly entered into by Irish SPVs, which would generally be considered financing transactions from a commercial perspective, so as to confirm that the nature of the income received would be considered interest equivalent. The definition used in the Second Feedback Statement is helpful insofar as it allows a macro view of a transaction to be taken to determine if a payment is interest or economically equivalent, though it is not clear if specific cash flows which are not interest can be treated as interest where the transaction as a whole is a financing transaction and clear guidance on this would be helpful.

In this regard, the following are examples of some cash flows in transactions which should be treated as interest equivalent, notwithstanding their legal form:

(a) Payments to Irish SPVs pursuant to swaps or derivative instruments which replicate the performance of interest-bearing assets (such as loans or bonds). In a 'synthetic' CLO or financing transaction and Irish SPV may enter into a derivative rather than purchasing a loan portfolio, though economically the outcome is the same (and the transaction is a financing in substance).

(b) Guarantee or credit default swap payments to Irish SPVs where the guarantee or swap is related to a broader financing transaction. In many cases, an Irish SPV may (as part of a larger transaction) provide guarantees or enter into swaps which facilitate greater use of capital by financial institutions (and are therefore equivalent to lending money).

(c) Dividends and other amounts received on equities or other financial assets which are swapped by Irish SPVs for amounts which are used to pay interest on notes or bonds (this is common in a repackaging transaction where Irish SPVs issue notes to finance financial assets and enter into swaps to replicate an interest return).

(d) Dividends or other amounts received by Irish SPVs in relation to repo transaction or stock loans which are exchanged by Irish SPVs for interest or equivalent amounts of lending fees, where the transition is commercially a financing transaction of bonds of securities.

(e) Foreign exchange (FXs) gains and losses on the principal amount of borrowings (as opposed to the interest expense) should not be considered to be interest equivalent when determining an Irish SPVs exceeding borrowing costs.

<u>Question 12</u>

Comments are invited on this possible approach to the "group of one".

We support the proposed approach to the "group of one". In *ICI v Colmer* (Case C-264/96) the Court of Justice of the European Union ("**CJEU**") determined that measures that discriminated against companies based on whether they formed branches or subsidiaries (or not) were in breach of freedom of establishment principles. Ireland changed its domestic law to comply with this decision. Many other decisions of the CJEU on freedom of establishment confirm the application of this principle. Accordingly, it seems that Ireland is obliged to treat a group of one that is not a standalone entity in the same way as a worldwide group, i.e. Ireland is required to apply Article 4(5) to the group of one in addition to the other computational rules.

However, we consider that the exclusion for related parties should be removed or replaced with associated enterprises as explained further below.

The definition of 'worldwide group' as proposed in section 3.6.1 (one based on a consolidated group for financial accounting purposes, i.e. including the parent company and all entities which are fully consolidated on a line-by-line basis in the parent's consolidated financial statements) is in line with both ATAD Article 2(10) and the OECD Action 4 Report – 2016 Update and is a practical and workable definition of a worldwide group for the purposes of both the equity ratio rule and the group ratio rule. Third-party borrowings / debt for these purposes would be borrowings other than with a member of the 'worldwide group'. If so, third-party borrowings could therefore include borrowings with associates and related parties who are not themselves members of the worldwide group.

As indicated in our response to the First Feedback Statement, the OECD Action 4 Report – 2016 Update notes that a group ratio rule defined in this manner should be supported by a targeted rule to address the risk that a group ratio could be inflated using interest paid to a related party outside the group and gives examples of paying interest under a structured arrangement (e.g. a back-to-back arrangement), excessive interest payments to a related party or interest to a related party which is subject to no or low taxation on the corresponding interest income. As we explained, Ireland already has many targeted rules which would disallow an interest deduction in these circumstances (e.g. Section 835AJ (Financial instrument deduction without inclusion mismatch outcome), Section 835AU (Structured arrangements), our recently amended Transfer Pricing provisions, Section 130(2)(d)(iii)(II) in respect of excessive interest) etc. We would submit therefore that the adjustments in the case of a 'single company worldwide group' in respect of debt with related parties as suggested in the sub-paragraph (3) of the proposed equity ratio rule in section 3.6.2, and in disregarding transactions with related parties as suggested in paragraph (2) of the definition of 'group ratio' in section 3.7.1, should not therefore be required. However, if it is considered that a targeted rule is required with respect to a 'single company worldwide group' (group of one), we would recommend using the term 'associated enterprise[s]' (as suggested with respect to the definition of 'standalone entity' in section 3.2.2) as an alternative to the term 'related parties' which as an accounting concept could differ as between accounting standards and be subject to differing interpretations.

Separately, as outlined in our response to Question 2 above, to the extent that the members of an interest group are not themselves members of an accounting group (i.e. there is no consolidation as between the interest group or any member in the interest group, and any entity outside the interest group), the interest group as single 'taxpayer' should be treated as a 'group of one' ('single company worldwide group'). The suggested definition of 'single company worldwide group' could be amended as follows:

> ***'single company worldwide group'*** *means a company,* ***<u>or where section xxx [interest group provision] applies, the interest group</u>****, that is not a member of a worldwide group and is not a standalone entity.*

<u>Question 14</u>

Comments are invited on the proposed definitions of 'disallowable amount', 'de minimis amount', 'allowable amount', 'EBITDA limit' and 'limitation spare capacity'.

We note that there has been a change to the proposed approach to the "*de minimis amount*" between the two feedback statements.

In the First Feedback Statement, the *de minimis* amount of €3m was a component (deducted from "exceeding deductible interest equivalent") in the calculation of "exceeding borrowing costs" which meant that if "exceeding deductible interest equivalent" was more than €3m, the 30% EBITDA restriction applied to the excess only. In the Second Feedback Statement, the *de minimis* exemption is now referred to in the definition of '*allowable amount*', defined as the greater of (a) 30% of EBITDA or (b) €3m. Where exceeding borrowing costs, excluding for this purpose the *de minimis* amount, are greater than the allowable amount, the excess will be a disallowable amount.

This gives rise to the following changes in how much exceeding deductible interest equivalent is allowable where it exceeds €3m:

(i) If 30% of EBITDA is greater than €3m, exceeding deductible interest equivalent is allowable up to 30% of EBITDA. Previously, the 30% EBITDA restriction would have been applied to the amount by which exceeding deductible interest equivalent exceeded €3m.

(ii) If 30% of EBITDA is less than €3m, the difference between exceeding deductible interest equivalent and €3m is now disallowed. Previously the 30% EBITDA restriction would have been applied to the difference.

It is not clear what the rationale is for the change in approach and our view is that the approach set out in the First Feedback Statement is consistent with the terms of the ATAD Directive.

IDSA

16 August 2021