Philip Murphy
Tax Director, KPMG

Finance Acts 2016 and 2017: Changes to the Tax Landscape for Investment in Irish Property-Related Assets

Introduction

Finance Act 2016 introduced a new taxing regime applicable to regulated funds that hold Irish real estate and certain related assets (defined as Irish real estate funds, or IREFs), in addition to implementing a significant amendment to s110 TCA 1997 in relation to securitisation vehicles that hold certain assets deriving their value from Irish real estate. Overviews of these changes have been included in previous *Irish Tax Review* articles.[1]

1 Peter Vale and Billy McMahon, "New Tax Landscape for Irish Property Funds: Finance Act 2016", and Séamus Kennedy, "Finance Act 2016 Changes to the Irish Securitisation Tax Regime", both in *Irish Tax Review*, 30/1 (2017).

Both of these new regimes introduce a level of tax cost for some non-resident investors holding Irish property, and property-related assets, via regulated fund structures or securitisation companies that are taxed in accordance with s110 TCA 1997 ("s110 companies"). The measures were aimed at counteracting a perceived erosion of the Irish tax base in relation to Irish property-related assets.

This article discusses the developments and trends in relation to these changes in the year that has passed since their introduction, in addition to noting amendments to the relevant Finance Act 2016 changes that were made by Finance Act 2017.

IREF Changes

Background to Finance Act 2016 changes

Before Finance Act 2016, the established and long-standing gross roll-up taxing regime that applied to all Irish regulated funds (other than investment limited partnerships and common contractual funds) provided for a clear tax analysis in the context of a non-resident investor, i.e. no Irish tax in relation to investment returns earned by the fund, with no tax on payments to the investor once a declaration of non-Irish tax residence was provided to the fund. Any investment return earned by non-resident investors would therefore potentially be taxable only in their jurisdiction of tax residence, with no Irish tax arising on the investment return earned by the fund or the realisation of this investment return by the investor. In the context of a property market that has seen significant increases in values since 2011, it was perceived that non-resident investors were using regulated fund structures to realise gains on Irish property and property-related assets, without any liability to Irish tax arising. The provisions introduced by Finance Act 2016 sought to eliminate the ability of non-resident investors to earn returns from Irish property and related assets without paying Irish tax by altering the established gross roll-up regime for certain regulated funds holding Irish real estate and related assets (such as REITs, and shares in property companies).

Broadly, the IREF provisions in Finance Act 2016 introduced a new 20% withholding tax in respect of certain Irish property-related distributions or payments on redemptions made by IREFs to certain unit-holders (such as non-resident investors). This tax is separate from the exit tax regime that generally applies to Irish regulated funds and, in general, should apply only to certain investors who would otherwise be exempt from exit tax. Although the concept of a 20% withholding tax applying to payments made by a fund sounds straightforward, in practice the provisions introduced were extremely complex, with a plethora of new definitions, anti-avoidance measures and specific aspects to deal with practical nuances of the funds industry.

Key aspects of IREF legislation

To contextualise some of the practical issues that arose after the legislation was introduced, in addition to the amendments made in Finance Act 2017, the following detailed aspects of the IREF regime introduced by Finance Act 2016 are relevant:

Concept of an IREF

For the purposes of the rules, an IREF is any Irish regulated fund (other than a UCITS[2] authorised fund, common contractual fund or investment limited partnership) where 25% or more of the market value of its assets is derived (directly or indirectly) from "IREF assets". IREF assets include:

- Irish land and buildings,
- unquoted shares deriving their value (or the greater part of their value) directly or indirectly from Irish land and buildings,
- shares in a REIT,

2 Undertakings for collective investment in transferable securities.

- specified mortgages (as defined in the context of the provisions introduced to s110 by Finance Act 2016) and
- units in another IREF.

Excluded investors

IREF withholding tax is intended to apply to investors who do not suffer exit tax (also referred to as investment undertaking tax) under the existing gross roll-up regime (e.g. non-resident investors who have provided a declaration of non-Irish tax residence to the fund). As a result, Irish individuals will not be subject to IREF withholding tax and will continue to have exit tax deducted in relation to payments made to them. However, the IREF legislation also seeks to exclude certain types of "good" investors from the IREF withholding tax. These include (among others) certain Irish and equivalent EU regulated funds, Irish and equivalent EU pension funds, Irish and equivalent EU life assurance funds and certain Irish registered charities. There is a requirement for investors to self-declare their exempt status to the IREF via a standard Revenue-approved declaration form that has been released.

Calculation methodology

A specific calculation methodology must be followed in determining the amount to which the 20% withholding tax should apply. Broadly, this calculation aims to apply withholding tax only to the amount of the payment (e.g. distribution or redemption proceeds) that relates to the profits arising from IREF assets. As a result, if an IREF held Irish property in addition to other assets (e.g. bonds or equities), withholding tax should apply only to the profits generated in respect of the Irish property. Furthermore, in calculating the amount to which withholding tax is applicable, Finance Act 2016 provided that any unrealised profits or gains relating to Irish property booked in the IREF's accounts and/or realised gains in respect of disposals of Irish relevant assets that have been owned for at least five years by the IREF can be excluded (unless the IREF is a personal portfolio IREF for the investor – discussed below).

Personal portfolio IREF concept

The legislation introduced the concept of a personal portfolio IREF (PP IREF), which, broadly, is an IREF where some or all of the IREF assets or IREF business may be, or was, selected or influenced by an investor or a person acting on the investor's behalf or connected with the investor. There are some negative implications for any investor in respect of which a fund is considered a PP IREF. For example, under the Finance Act 2016 rules, it is not possible to exclude unrealised movements or realised gains on properties held for longer than five years where the IREF is a PP IREF for any investor (and, as a result, a higher level of withholding tax would likely arise for such an investor).

Refund mechanism

In general, IREF withholding tax is intended to be a final tax on payments to in-scope investors and must be returned each year by the IREF to Revenue. However, in some cases, non-resident investors in an IREF who are subject to IREF withholding tax may be entitled to make a reclaim for some or all of the withholding tax. This could arise where the IREF has applied withholding tax as a result of the required declaration evidencing exempt status not being provided by the investor or where the investor is entitled to a reduced rate under the terms of a double taxation agreement entered into between Ireland and the investor's country of tax residence. The IREF provisions specifically provide for refunds of tax withheld where the investor is entitled.

Character of payments for tax treaty purposes

Where an investor holds more than 10% of the units in an IREF, provision was made to restrict the ability of the investor to achieve a refund of withholding tax under a double taxation agreement. This is achieved by reclassifying distributions as income from immoveable property (which is generally not capable of reduction under Ireland's tax treaties).

Secondary-market transactions

Where investors dispose of their units in an IREF to another person (i.e. rather than redeeming their interest and receiving a payment from the fund), the IREF is not in a position to deduct withholding tax as it does not make a payment. In such instances the investor is subject to tax on a self-assessment basis. In addition, where the consideration exceeds €500,000, the purchaser is obliged to withhold 20% from the gross sales proceeds and remit it to Revenue. In some cases, the seller will be entitled to a refund of any tax in excess of the actual tax due on the disposal.

Developments after introduction of legislation

Background to developments

As with any piece of newly introduced legislation, there were a number of teething problems with the IREF provisions as legislated for by Finance Act 2016. Issues such as these are generally teased out in conjunction with relevant stakeholders as the Finance Bill makes its way through the various stages of the Oireachtas, but due to the complexity of the regime and the time available before the Finance Act was signed into law, not all issues were identified and resolved before the Act was signed. (As an indication of the complexity, the legislation increased from just under 4 pages in the initial draft of Finance Bill 2016 to more than 18 pages in Finance Act 2016.) As a result, there were a number of aspects that needed to be clarified through a combination of Revenue guidance and legislative amendments to be made in Finance Act 2017. These included:

- expanding the list of "good" investors to include investment savings products such as PRSAs and ARFs,[3]
- making necessary provision to allow for intermediaries to provide declarations on investments held by "good" investors via nominee arrangements,
- introducing an advance clearance mechanism for refunds of withholding tax suffered directly or indirectly by certain investors,
- including provisions on multi-tiered IREFs, i.e. where one IREF invests in another (to prevent a double charge of tax arising in certain fact patterns),
- providing greater clarity on when a fund would be considered a PP IREF from the perspective of an investor (given the inherent subjectivity related to the broad definition in the legislation as introduced) and
- providing guidance on the "equivalence" tests in the context of EU pension funds and life assurance companies (again, given the subjectivity).

Revenue guidance

Finance Act 2016 was signed into law by the President on 25 December 2016, with the provisions applicable to funds with an accounting period commencing on or after 1 January 2017. Given the relatively short timeframe in which the legislation was introduced, Revenue actively engaged with industry working bodies to identify and understand any issues in the legislation as drafted. During 2017, Revenue guidance on a number of such issues was provided in the following eBriefs.

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3 Personal retirement savings accounts and approved retirement funds.

4 Approved minimum retirement funds.

Revenue eBrief No. 10/2017 (31 January 2017)

This eBrief updated the Revenue Tax and Duty Manual to include the standard declaration forms that "good" investors could provide to funds to allow for the non-application of IREF withholding tax to payments made to them. Additionally, it clarified that established funds had until 1 July 2017 to ensure that the declarations were in place for their investor base (even in relation to taxable events arising between 1 January 2017 and 30 June 2017).

Revenue eBrief No. 26/2017 (20 March 2017)

This eBrief further updated the Revenue Tax and Duty Manual to include standard declaration forms in relation to an intermediary acting on behalf of pension schemes, PRSAs, ARFs, AMRFs[4] or charities. Although the legislation as drafted did not allow for these types of investors to be treated as "good" investors, Revenue published this guidance to ensure that investors had certainty on the treatment before the position was rectified in Finance Act 2017.

Revenue eBrief No. 70/2017 (28 June 2017)

This eBrief set out an agreed administrative practice to allow non-application of IREF withholding tax to "good" investors who (1) indirectly invest in an IREF and (2) would otherwise have been required to apply for a refund of withholding tax. This administrative practice required an upfront application to Revenue to allow gross payments to such investors, reducing a potential cash-flow issue for them as a result of otherwise being required to suffer withholding tax and subsequently submit a refund application.

Revenue eBrief No. 81/2017 (18 September 2017)

This eBrief updated the Revenue Tax and Duty Manual to provide Revenue's view on when an IREF would be considered a PP IREF in the context of a particular investor. Given the potential subjectivity regarding the concept of a PP IREF, it includes a number of practical examples that were worked through in conjunction with discussions between Revenue and industry working groups.

As well as publishing the guidance noted above, Revenue has been open to engagement with practitioners on any additional aspects of uncertainty, recognising the fact that the regime is complex and that funds require some degree of certainty on the withholding tax position before making payments to investors. An example in this regard is the concept of equivalence in considering whether an EU pension fund, life assurance company or investment fund is a "good" investor, and therefore not subject to IREF withholding tax, whereby Revenue has been engaging with practitioners on a case-by-case basis in light of the subjectivity.

Legislative amendments

A number of legislative amendments were made to the IREF provisions in Finance Act 2017 to provide a legislative basis for some of the practices that Revenue had published and been applying after the rules were introduced and to deal with some of the additional technical issues identified by stakeholders. A summary of the key changes in legislation is given below.

5 Markets in Financial Instruments Directive.

Table 1: Amendments to the Finance Act 2016 IREF provisions made by Finance Act 2017.

Finance Act 2016	Finance Act 2017
Legislation provided that only "good" investors could declare entitlement to exemption.	Declarations evidencing exempt status can now be provided by an MiFID[5] regulated intermediary holding the IREF shares/units on behalf of a "good" investor.
Legislation included a refund mechanism for "good" investors.	It is now possible for "good" investors to seek advance clearance that payments can be made gross in the context of (1) secondary-market transactions where the consideration exceeds €500,000 (in which case the purchaser would otherwise be obliged to withhold 20% from the gross sale proceeds) and (2) indirect investments held in an IREF whereby withholding would not apply if the investment were held directly.
The definition of IREF assets (i.e. assets factored in when considering the 25% test) excluded listed shares deriving their value from Irish property.	For listed shares deriving their value from Irish property to be excluded, the quoted shares must be regularly and substantially traded.
Where an investor holds more than 10% of the units/shares in an IREF, the ability of the investor to achieve a refund of withholding tax under a double taxation agreement is restricted.	The provisions were extended to capture situations where two or more connected persons each own less than 10% of the units/ shares but between them own more than 10%.
In calculating the withholding tax applicable to an investor in respect of which the fund is not considered a PP IREF, it was possible to excluded unrealised gains, in addition to any realised gains on disposals of land and buildings that were held by the IREF for a period of at least five years.	From 1 January 2019, when computing the withholding tax applicable, it will no longer be possible to exclude unrealised gains, or realised gains on disposals of land and buildings that were held by the IREF for a period of at least five years.
The categories of "good" investors included certain Irish and equivalent EU regulated funds, Irish and equivalent EU pension funds, Irish and equivalent EU life assurance funds and certain Irish registered charities.	The categories have been expanded to include ARFs, AMRFs and PRSAs.

In addition to the above, a further amendment was made in Finance Act 2017 to remove a potential double charge to IREF withholding tax where one IREF holds units in another IREF and the subsidiary IREF is considered a PP IREF in respect of the parent IREF. Finance Act 2017 remedied this by removing the charge to IREF withholding tax on payments from the subsidiary IREF to the parent IREF provided that the holding of the units in the subsidiary IREF is for bona fide commercial reasons and is not part of a scheme or arrangement the main purpose (or one of the main purposes) of which is to avoid Irish tax.

The various changes noted above are broadly positive from the perspective of IREFs, as they seek to ensure that the legislation works as intended while providing clarity on any technical issues identified. Regarding the change to the calculation methodology, it is worth noting that this will give rise to an increased level of withholding tax for investors in some IREFs from 1 January 2019. However, it is not expected that it will have a widespread impact on all IREFs, as many IREFs in practice are considered PP IREFs in the context of their investors (in which case unrealised gains and gains on disposals of land and buildings that were held by the IREF for at least five years cannot be excluded under the Finance Act 2016 rules).

From the perspectives of practitioners and fund administrators, this change will reduce the complexity of the calculation methodology, as it will mean that the full amount of profit from IREF assets will be subject to withholding tax when paid to investors, reducing the level of historical information required when preparing calculations.

With the exception of the change in calculation methodology, all of the amendments noted are currently in force, as the Finance Act 2017 amendments are effective for IREF taxable events occurring on or after 19 October 2017.

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IREFs: A lot done, more to do?

Since the publication of Finance Bill 2016 significant time has been spent by practitioners, Revenue, service providers (such as fund administrators) and other affected stakeholders on ensuring that the legislation is as clear as possible and operates as intended. Although the legislation remains complex, many of the teething issues have been resolved in the year since it was introduced. Therefore, it is not expected that significant future amendments to the regime will be needed. There are still some aspects of uncertainty, such as the equivalence test in the context of "good" EU investors, but it is expected that case-specific engagement with Revenue will continue to be the appropriate manner to deal with such issues.

As we move toward the first return filing date in 2018 (which will be 30 June 2018 for an IREF with a 31 December 2017 financial year-end), it is expected that Revenue will shortly release a standard return form to be completed by IREFs in conjunction with their investment manager, fund administrator and tax adviser (where relevant).

Section 110 Changes

Background

Ireland's securitisation regime, the provisions of which are included in s110 TCA 1997, was the subject of much discussion in the build-up to Finance Act 2016. This was due to the perception that the regime was being used in ways that were not intended when the section was introduced, particularly in relation to property-related assets (e.g. loans secured on Irish property).

An s110 company is a normal Irish company that, provided it meets certain upfront and ongoing conditions set out in s110 TCA 1997, can elect to be taxed in accordance with the provisions of s110 TCA 1997. Broadly, these provisions allow securitisation of assets in a relatively tax-neutral manner. This is achieved by disapplying provisions that would otherwise reclassify profit-dependent interest as a non-tax-deductible distribution, meaning that an s110 company can (subject to specific anti-avoidance provisions) avail of a full tax deduction for profit-dependent interest.

Although s110 companies cannot hold Irish land and buildings directly, before Finance Act 2016 there was a significant level of negative publicity in relation to s110 companies that had acquired portfolios of loans secured on Irish property, whereby the above provision meant that profits were realised in some instances without triggering any meaningful level of Irish tax. Similar to the perception of regulated funds holding Irish property directly, there was a resultant concern about the perceived erosion of the Irish tax base by certain s110 companies holding Irish property-related loans and assets.

A draft of the legislative amendments designed to address these concerns was published on 6 September 2016, and after a period of consultation, a somewhat modified version of these proposals was included in Finance Act 2016.

What has changed?

In broad terms, to the extent that an s110 company owns or manages "specified mortgages" (as defined), these assets are treated as part of a separate business, known as a "specified property business", carried on by the company.

"Specified mortgages" are defined as:

(1) *loans that are secured on and that derive their value or the greater part of their value (directly or indirectly) from Irish land and buildings;*

(2) *swaps or similar derivatives that derive their value or the greater part of their value (directly or indirectly) from Irish land and buildings or loans to which (1) applies (other than such investments that derive the greater part of their value from those types of excluded securitisation transactions discussed below);*

(3) *units in an IREF; and*

(4) *profit-participating loans (or part thereof) issued by another s110 company that fund, and are attributable to, its "specified property business".*

Where an s110 company holds any of the above assets and is considered to be carrying on a "specified property business", although the general rules in s110 TCA 1997 will continue to apply to the specified property business, interest deductions in respect of profit-participating loans are restricted to the amount of interest that would have been payable if the loan was a non-profit-participating loan and was instead entered into by way of a bargain made at arm's length. The net effect of this change is that additional tax liabilities might arise for s110 companies holding Irish property-related assets. This is on the basis that any accounting profits would be previously have been reduced to a low level of taxable profits by virtue of the tax deduction available for interest accrued or paid in relation to profit-participating loans issued by the s110 company. However, under the revised rules, the level of tax deduction available is limited to an arm's-length amount, which may be lower than the level of profit-participating interest in some instances.

It is worth noting that, where a number of conditions are met, certain types of securitisation transactions, such as collateralised loan obligation transactions or loan origination activity, are outside the scope of the changes. Furthermore, the new rules provide that interest to which withholding tax applies will not be restricted.

In addition, no restriction is to apply in respect of interest paid to certain categories of investors, such as Irish tax-resident individuals, Irish and EU pension funds and IREFs.

An additional change introduced by Finance Act 2016 accelerated the timeline in which a company electing into the s110 regime is required to file a once-off notification with Revenue (making this election is one of the conditions of s110 TCA 1997). Previously, this notification was required before the filing of the first corporation tax return due by the company. However, the company must now file the notification within eight weeks of its commencement of activities and must also provide additional information in respect of its activities, including details of the type of transaction, assets acquired, name of originator, details of any intra-group transactions and names of any connected parties. This accelerated notification requirement applies to all new s110 companies, not just those that own or manage "specified mortgages". In this regard, Revenue has recently published eBrief No. 125/2017 (28 December 2017), which updates its Tax and Duty Manual to note circumstances in which it will accept s110 notifications outside of the prescribed timescale.

Finance Act 2017 amendment

Finance Act 2017 amended the definition of "specified property business", to include in the definition a business (or that part of the business) that includes the holding and/or managing of shares that derive their value, or the greater part of their value, directly or indirectly from Irish land and buildings.

The expanded definition of "specified business property" (and the resulting restriction on the deductibility of interest on profit-dependent loans attributable to that "specified property business") is applicable to interest paid on or after 19 October 2017.

Practical impact of changes

The new rules introduced by Finance Act 2016 apply to accounting periods commencing on or after 6 September 2016. However, where a company had an accounting period spanning this date, there was a requirement for the period to be notionally split, with the new rules applying to the second part. As many s110 companies to which the new rules applied had not recognised unrealised gains that accrued before 6 September 2016 in their accounts (due to accounting concepts whereby such gains are not accounted for until they are actually realised), the companies were subject to the new rules in respect of such unrecognised gains, notwithstanding that the increase in value in the assets occurred before the change in law. This resulted in a material and unexpected tax cost for some s110 companies.

Although an s110 company is subject to Irish corporation tax at the rate of 25% under Case III of Schedule D, it computes its taxable profits in accordance with Case I principles (other than in relation to profit-participating interest). As a result, any tax cost arises at 25%, rather than at the 12.5% trading rate that would apply if the company was regarded as carrying on a trade for Irish tax purposes. For this reason, some s110 companies have elected out of the s110 regime where they have sufficient substance and activity to support a position that they are carrying on a trade for Irish tax purposes.

The amendments have also given rise to significant additional complexities in the context of preparing corporation tax computations for an s110 company in scope of the provisions, as there is now a need to:

- split the relevant income and expenses of the company between its "specified property business" and other activity, and
- ensure that an appropriate transfer pricing exercise has been undertaken to support the level of interest deduction in respect of the specified property business.

Conclusion

The changes made in the context of IREFs and s110 companies have added significant complexities and considerations for practitioners, clients and other service providers involved in investment in Irish property-related assets. In the year since their introduction, many of the practical issues have been identified and ironed out. Therefore, although the changes reduce the attractiveness of investment in Irish property-related assets for non-resident investors (as they introduce a level of tax cost), on a positive note, as a result of the Finance Act 2017 legislative amendments and the Revenue guidance issued during 2017, we now have taxing regimes that are clearer and it is possible to provide some level of certainty to non-resident investors on how their return will be taxed.

Both Irish regulated funds and s110 companies can continue to serve as tax-efficient investment holding platforms for asset classes that are unrelated to Irish property. However, in the context of Irish property-related assets, the changes mean that they may not always represent the most tax-efficient investment holding vehicle for non-Irish investors going forward.

Read more on taxfind From Irish Tax Institute New Tax Landscape for Irish Property Funds: Finance Act 2016, *Irish Tax Review*, Issue 1, 2017; Finance Act 2016 Changes to the Irish Securitisation Tax Regime, *Irish Tax Review*, Issue 1, 2017