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TAX

Guidance on the Interest Limitation Rule (ILR) published

Eight months on from the implementation of the ILR the Irish Revenue Commissioners have, following industry consultation, published guidance on the ILR. This article focuses on the guidance given on the meaning of ‘interest equivalent’ income and the examples given of such income.

8 MIN READ

Background

Earlier this year the A&L Goodbody Tax team published an article (Implementation of the Interest Limitation Rule (the ILR) in Ireland) detailing the principal aspects of the ILR and its practical implementation pursuant to Finance Act 2021. Since enactment of the ILR the Irish Revenue Commissioners, in consultation with interest parties, have been working on accompanying guidance. That guidance was published on 4 August 2022 and sets out information in relation to, among other things, various terms, phrases and definitions necessary for the operation of the ILR including the meaning of 'interest equivalent, the calculation and impact of EBITDA, calculation and application of the space capacity concept, the application of group reliefs, the application of the ILR to interest groups, etc. This article focuses on the concept of interest equivalent income and the practical examples referenced in the guidance.

What is meant by interest equivalent income?

Case law has long defined the term 'interest' as a payment by time for the use of money. The term 'interest equivalent' includes amounts which are economically equivalent to interest. The concept of interest and interest equivalent income is critical to determination of the impact of the ILR. Interest equivalent income includes, for example:

- interest
- amounts economically equivalent to interest (e.g. a discount where securities are issued at a discount, the finance element of finance lease payments, amounts under derivative instruments or hedging arrangements directly connected with the raising of finance)
- amounts arising directly in connection with raising finance (including guarantee, arrangement and commitment fees)
- foreign exchange gains and losses on interest or amounts economically equivalent to interest
- any amount arising as part of an arrangement that could be reasonably considered, when the arrangement is looked at in the round, to be economically equivalent to interest.

The guidance indicates that the ILR applies to interest on all forms of debt and to other amounts economically equivalent to interest. It also applies to other expenses incurred directly in connection with the raising of finance which could be substituted for interest. In this regard the guidance details a number of useful example scenarios:

1. Discount/Arrangement Fee/ Premium

Scenario

A trading company raises finance by issuing discounted interest bearing loan notes redeemable at a premium on maturity and incurs arrangement fees in respect of the issuance.

Treatment

- The interest, discount on issue, premium on redemption and arrangement fees are all treated as being 'interest equivalent'.

2. Guarantee Fee

Scenario

A company obtains financing to acquire a property and a guarantee is provided by a parent company to the lending bank in return for a fee being paid by the borrowing company.

Treatment

- The guarantee fee is considered to be 'interest equivalent'. Other fees that are not directly connected with the raising of finance (e.g. property valuation and legal (conveyancing) fees) are not interest equivalent.

3. Derivative/hedge agreements

Scenario

Two companies with borrowings enter a swap agreement, one to benefit from the potential upside of securing a variable interest rate and the other to fix its interest exposure. Each makes an interest payment and a payment under the swap and each obtains a swap receipt.

Treatment

- The interest payments and swap payments by each company is treated as being deductible interest equivalent. The swap receipts of each company is treated as taxable interest equivalent income.

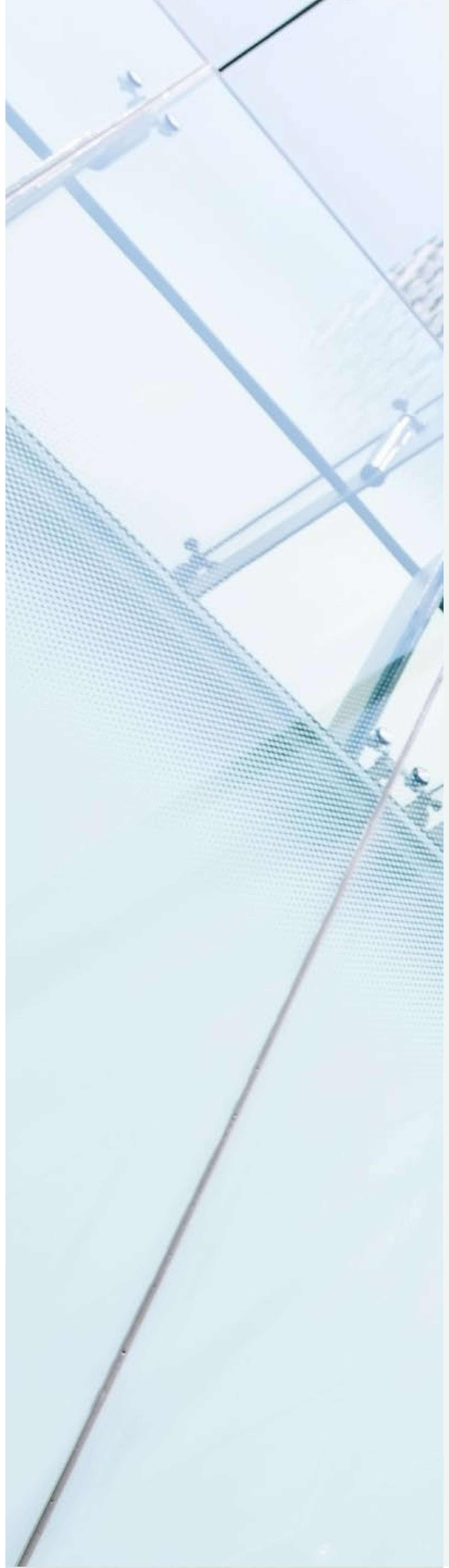
4. Non-performing loans (NPLs)

Scenario 1 – where a company uses and effective interest rate method of accounting in respect of the acquisition of the NPLs

A company buys a portfolio of NPLs for a discounted amount 'X' in expectation of cashflows from future interest receipts and principal of 'Y' as against the actual higher non-impaired contractual cashflows. A credit adjusted effective interest rate is calculated as the internal rate of return (IRR) of the purchase price (i.e. X) and the cashflows expected to be collected (i.e. Y). That IRR represents the annual interest return on the purchase price and is recognised in the company accounts as finance income.

Treatment

- Where the IRR matches the actual cashflows all amounts recognised as finance income in the company's accounts should be treated as interest equivalent income. This on the basis that it is the profit on a financial asset the return on which can reasonably be considered to be economically equivalent to interest.
- Where the actual cashflows (interest/ principal) are greater than the IRR, the gain (i.e. in effect the income exceeding the IRR) is not economically equivalent to income. This is because the gain is a return in excess of the expected financing return of Y. That gain is accounted for as a gain in the income statement of the company and is taxed at 33%.
- Where the actual cashflows are less than the IRR that shortfall is treated as an impairment loss in the company's accounts. It is treated as deductible interest equivalent income given it represents a reduction in the profit of a financial asset, the return on which principally comprises interest.



Scenario 2 – where the company uses fair value accounting

Similar principles to those outlined in scenario 1 above apply where the NPLs are subject to fair value accounting in the income statement. Amounts recognised in the income statement are treated as being interest equivalent unless the movement in fair value reflects

- an increase in the value of the loan portfolio due to greater expected cashflows than anticipated at acquisition, or
- a decrease in the value of the loan portfolio below cost.

5. Trading in receivables

Scenario

ABC Co issues notes and uses the proceeds to acquire trade receivables from XYZ Co at a discount to their face value. The profit earned by the ABC Co on the receivables (i.e. the difference between what it paid for them and what it collects from the obligors) is used to pay interest and principal owing to its noteholders.

Treatment

- The receivables factoring is viewed as a financing transaction. The discount applied to the receivables is treated as a financing cost for XYZ Co and is equivalent to an interest expense.
- ABC Co receives income from the receivables equal to the discount applied. This is treated as being equivalent to interest as it is the return earned by it for providing financing to XYZ Co.
- ABC Co pays interest on the notes to its noteholders. This is a borrowing cost of ABC Co and is treated as being interest equivalent.

6. Securitisation

Scenario

A company issued funding notes and uses the proceeds to acquire performing mortgages from the originator. The originator retains a 5% net economic exposure in the securitisation for regulatory compliance purposes. The company also enters into a swap agreement to reduce the risks of payment mismatches due to interest rate or currency mismatches or the timing of payments. The profits on the mortgages are used by the company to pay interest and principal owing to its noteholders.

Treatment

- Taken in the round the profits arising to the company on the transaction should be treated as taxable interest equivalent income and the payments on the notes should be treated as deductible interest equivalent income.

7. Repo transactions

Scenario

A company issued funding notes to investors and enters into a repo agreement with a bank to purchase shares from the latter which will be repurchased at a future date at a fixed price from the company. The bank pays a repo fee to the company for entering the swap. The company receives dividends on the share and makes equivalent payments to the bank. Amounts received by the company under the repo are used to pay interest on its notes. The proceeds of the sale back of the shares to the bank are used to redeem the principal on the notes.

Treatment

- The income earned by the company from the repo fee is interest equivalent income as it represents the return earned by it for providing financing to the bank. The interest paid by the company to its noteholders is a borrowing cost and is treated as being interest equivalent.

8. Synthetic securitisations

Scenario

To mitigate its credit risk on a portfolio of performing loans and to reduce the regulatory capital requirements a company buys credit protection on the portfolio. An SPV issues notes to investors at an arm's length interest rate set by the prevailing market and the credit profile of the loans. The SPV sells credit protection to the company for a fee and earns a margin based on the difference between the rate of interest on the notes it issued and the amounts it is entitled to receive from the company for providing the credit protection.

The income of the SPV is made up of (i) the credit protection fee and (ii) any return on the collateral it uses to fund paying interest on the notes it issued to investors and its expenses. Under the credit protection agreement if a default occurs on the loan portfolio the SPV will make credit protection payments to the company to compensate it for the losses it suffers on the loans. A corresponding reduction of the principal amount of the notes issued by the SPV means the investors are in effect exposed to the credit risk on the portfolio.

When the credit protection ultimately terminates and remaining funds in the SPV are returned as principal on the notes to the investors.

Treatment

- Viewed in the round the arrangement results in the SPV (and its investors) sharing in the credit risk on the portfolio. The credit protection fee paid by the company to the SPV is considered to be interest equivalent income for the SPV.
- On a loan default the SPV makes a protection payment to the company. Where that default relates to a write down of the principal on the loan portfolio the payment is not interest equivalent. The corresponding write down of the principal amount of the notes would not be interest equivalent either.
- Where the loan default relates to a write down of interest receivable on the loan portfolio the credit protection payment by the SPV would be interest equivalent and the corresponding write down of the principal amount of the nots is also interest equivalent.

9. Commodities

Scenario

A company issues funding notes and acquires commodities with the proceeds. The profit earned on the commodities is used to pay a return on the notes to the investors.

Treatment

- The return earned by the company on the commodities is not interest equivalent income. It is not interest and it is not economically equivalent to interest.

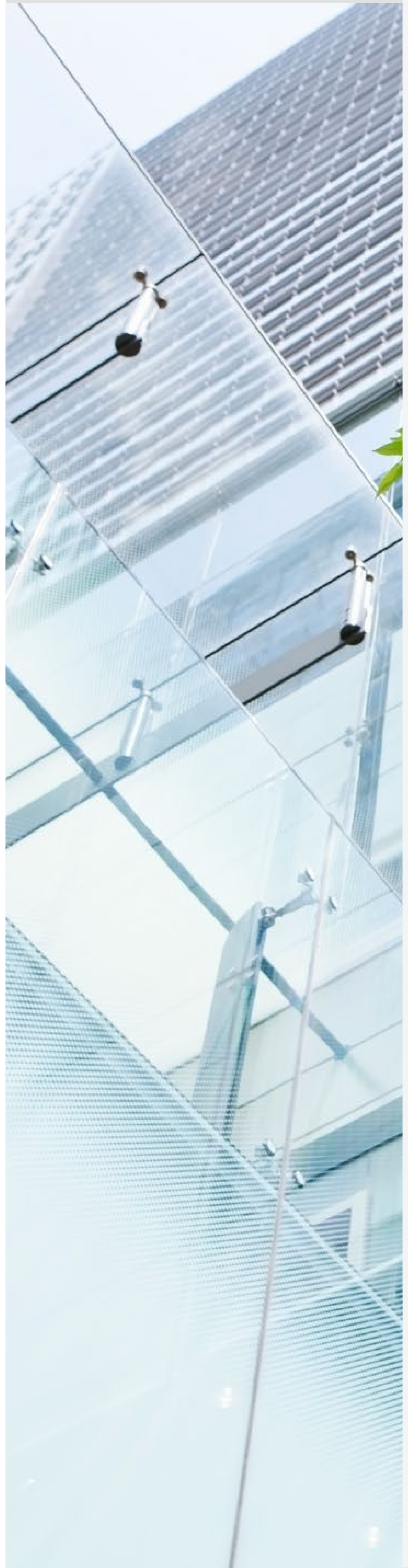
10. Stock lending

Scenario

An Irish bank enters into a stock lending transaction with a company to lend it stock in return for being paid (i) an arrangement fee , (ii) ongoing flows under the stock loan and (iii) manufactured payments for any dividends received by the company during the loan period. To hedge its risk of exposure to fluctuations in the value of the stock the bank enters a derivative contract with a hedge counterparty for which it will pay to it a fee as well as pay any gains in the stock value and dividends. Should the stock decrease in value the hedge counterparty will be pay the shortfall to the bank.

Treatment

- This is in effect a financing transaction from the bank's perspective. The return to the bank, being the arrangement fee, is economically equivalent to interest.



- Gains made by the bank on the stock and the manufactured payment it receives from the company are not associated with the holding of the stock and not in respect of the financing transaction. As such they are not interest equivalent income of the bank.
- In the same way payments under the derivative contract to hedge the bank's exposure to holding the stock are not directly connected with financing. As such amounts paid under the derivative contract are not interest equivalent.

11. Finance Leases

Scenario

A company enters into an arrangement to lease machinery. The lease transfers substantially all the risks and rewards incidental to ownership of the machinery. The cost of the lease includes an expected finance cost which will be recognised as such in the company's accounts.

Treatment

- The finance element of the finance lease payments is treated as being interest equivalent. Broadly this equates to the amount obtained by multiplying the annual lease payments by the expected finance cost recognised in the company accounts and dividing that by the total expected cost of the lease.

12. Non-finance lease payments

Scenario 1

A company engaged in the trade of leasing assets leases a machine under a non-finance lease to another company.

Treatment

- The finance income element of the non-finance lease payments of a company carrying on a trade of leasing is treated as being interest equivalent.

Scenario 2

A machine is leased under a non-finance lease to a company which itself is engaged in a trade of leasing assets.

Treatment

- The finance cost element of the non-finance lease payments of a company carrying on a trade of leasing is treated as being interest equivalent.
- In the case of the above scenarios the finance income/cost element is calculated based on applying formulas set out in law.

Conclusion

The publication of Revenue's guidance is a welcome development in providing some colour and clarity with respect to understanding the scope of the concept of 'interest equivalent' income.

The result is that for the scenarios outlined, the relevant entity will largely be considered to be receipt of income that is economically equivalent to interest (with some exceptions). As such the question of having exceeding borrowing costs and having to apply the 30% EBITDA cap or even the EURO 3 million threshold may not arise.

Of course some of these examples are overly simplified and do not cater for some real world variabilities but nevertheless provide a useful outline of the principles that Revenue consider relevant.

To the extent that a company does not have interest equivalent income to wholly shelter its interest expenses, the ILR may still have limited impact where it is possible to avail of, for example, single company worldwide group status and equity ratio relief. In this regard our previously published article (Implementation of the Interest Limitation Rule (the ILR) in Ireland) refers.

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