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TAX

Implementation of the Interest Limitation Rule (the ILR) in Ireland

The long awaited interest limitation rule was finally implemented in Ireland with effect from 1 January 2022.

The principal aspects of this rule and practical implementation are outlined in this note.

7 MIN READ

Background

On 12 July 2016 Council Directive (EU) 2016/1164 (the "**ATAD**") was formally adopted by the European Council. Recital 6 to the ATAD sets out the rationale for the introduction of the ILR. It recognises that groups of companies have increasingly shifted profits and eroded tax bases through excessive interest payments. To counter that a rule that limits deductibility of interest payments was considered necessary. The primary objective of Article 4 of the ATAD (i.e. the ILR) is to battle tax avoidance through excessive interest payments.

Article 4 of ATAD requires EU member states to implement an interest limitation ratio. The ratio has been designed to limit the ability of an entity to deduct net borrowing costs in a given year to a maximum of 30% of EBITDA. In other words, the ILR denies a tax deduction for the net interest expense (i.e. the gross interest expense less the interest and/or interest equivalent income) that exceeds 30% of EBITDA.

While ATAD set the date for implementing the ILR as 1 January 2019 the directive included a derogation allowing Member States, that already had nationally targeted rules for preventing interest related base erosion and profit shifting risks that were equally effective to the ILR, to defer implementation until potentially as late as 1 January 2024. Ireland initially indicated that it would avail of that derogation. However because the Irish tax rules on deductibility are structured differently to the ATAD EBITDA ratio rules the data collected by the Department of Finance to support derogating from the ILR was not deemed acceptable by the European Commission.

As a result, the Department of Finance indicated in a tax strategy paper published in the fourth quarter of 2020 that the process of transposing the ILR into Irish law was being advanced from the original planned deadline of 1 January 2024 to 1 January 2022.

Legislation was introduced in Finance Act 2021 and took effect for accounting periods beginning on or after 1 January 2022.

Effect of the ILR

To the extent that a company has 'exceeding borrowing costs', being its interest and interest equivalent borrowing costs as reduced by its interest and interest equivalent income, it will only be able to take a tax deduction for such excess interest costs up to 30% of its EBITDA.

However, excess borrowing costs are still fully tax deductible to the extent that they do not exceed €3m in a year. To the extent that the de minimis threshold is exceeded the entire amount of excess borrowing costs (rather than just the amount in excess of the €3m cap) is subject to restriction.

Exemptions from ILR

A number of potential exclusions from the ILR as permitted by ATAD have been included in the Irish implementation. In addition to the €3m a year de minimis cap referred to above, any adverse impact of the ILR can potentially be negated by the application of the single company worldwide group and group relief (equity and group ratio) concepts (see below).

In addition the ILR does not, for example, apply to:

Legacy Debt

Broadly this refers to debt the terms of which were agreed before 17 June 2016 and contracts entered into for the sole purpose of reducing interest rate risk on that debt. It excludes however drawdowns after that date where such drawdowns are not provided for in the terms agreed on the happening of milestones set out in those terms, before that date.

Standalone entities

A standalone entity is an entity without a foreign branch, which is not included in a financial statements group consolidation and has no associated enterprises. Standalone entities are exempt from the ILR.

While it had been anticipated that a section 110 qualifying company (an **SPV**) would have typically qualified as a standalone entity given it is common for an SPV to be an orphan entity (i.e. all the issued shares in the SPV are held by a corporate trustee on trust for charitable purposes), that is not the case. The corporate trustee is considered an associated enterprise of the SPV on the basis of having the right to at least 25% of the issued share capital, voting rights and/or right to profits.

Even though an orphan SPV is not exempt from the ILR under the standalone entity carve out, it would be anticipated that in many situations the SPV should qualify as a single company worldwide group and in that way should still not be adversely affected by the ILR (see below).

What constitutes interest equivalent income?

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 interest equivalent definition contains a number of welcome inclusions for the asset leasing industry. As noted above the definition specifically includes the finance element of finance lease payments. It also includes a portion of operating lease income and expense for lessors that carry on a trade of leasing (being the amount that represents the implicit interest rate included in the payment). This is a recognition of the fact that lessors are in reality providing a form of asset finance.

What happens to disallowed deductions?

To the extent that a company has excess borrowing costs such disallowed excess interest costs can be carried forward for potential deduction in future years. This assumes the company concerned will have sufficient capacity to claim the deduction (i.e. where in a later year it does not exceed the 30% of EBITDA threshold).

What if a company has unused capacity?

In the event that a company has exceeding borrowing costs below the 30% EBITDA threshold the unused amount can be carried forward as 'limitation spare capacity'. Where the company has financing income in excess of its borrowing costs, that excess is carried forward as 'interest spare capacity'. The carried forward capacity needs to be used within a 60 month period after which it lapses.

ILR and interest groups

It is possible for certain companies to elect to join an 'interest group' thereby allowing the ILR calculations to be done at a group level. This may be advantageous in certain instances where spare capacity can be pooled between group members. However the €3m de minimis limit is applied to the group rather than to each member of the group.

A company can elect to be a member of an interest group with other companies that are within the charge to Irish corporation tax and which are part of the same 'worldwide group' (i.e. broadly meaning a group the members of which are consolidated for accounting purposes prepared under IFRS or GAAP of certain countries). Alternatively a company can elect into an interest group where they are part of a corporation tax loss group (i.e. one company is the 75% subsidiary of another or both are 75% subsidiaries of a third company).

If a company elects into a group it cannot elect out of the group for three years.

Group reliefs

The ATAD directive permits Member States to include in their implementation certain ratios which are applied on a group basis that, in particular circumstances, permit excessive interest deductions on a greater than 30% EBITDA basis. These are:

- the "group ratio", allowing a relevant Irish group member to increase its excessive interest deductions up to the group level if that is greater than 30% of EBITDA
- the "equity ratio", which looks at whether the ratio of equity over total assets of the relevant Irish group member is no less than the group as a whole, and if it is not then there is no interest restriction.

Concept of a single company worldwide group (SCWG) and its application

A SCWG is a company that:

- is not a member of a 'worldwide group' (broadly, is not consolidated with another entity for accounting purposes under GAAP or an alternative body of accounting standards laid down in certain jurisdictions)
- is not a member of an 'interest group'
- is not a standalone entity (broadly is not a member of a worldwide group, has no associated enterprises and does not have a permanent establishment in a territory other than Ireland)

The SCWG concept was introduced to address situations where a company is not included in any consolidated financial statements on the one hand and yet does not qualify as a standalone entity on the other hand. Without this concept entities which fall between the two categories would be disproportionally impacted.

While a SCWG consists of only one company, in addressing ILR, it may be able to avail of the group reliefs referred to above.

Group ratio and the SCWG

In applying the group ratio to a SCWG the group exceeding borrowing costs and group EBITDA are calculated based on the financial statements of the company in accordance with Irish GAAP or international accounting standards and adjusted by disregarding transactions with associated enterprises.

Equity ratio and the SCWG

In applying the equity ratio to a SCWG the equity amount is increased by an amount representing the debt owing by the company to associated enterprises which gives rise to deductible interest equivalent.

Where a company with excessive borrowing costs qualifies as a SCWG, the ILR may still not restrict any interest deductibility on application of one of these ratios, provided the SCWG does not have any associated enterprises. From a practical perspective most bankruptcy remote SPVs involved in securitization and repackaging transactions should be treated as SCWGs and effectively outside the scope of the ILR.

Conclusion

Whether or not the ILR applies will ultimately depend on whether the company concerned has a net interest expense exceeding 30% of EBITDA. To the extent a company only has interest equivalent income the ILR should have no impact.

Even where there are excessive borrowing costs, the ILR will have no impact where that excess does not exceed €3m annually. In addition the group ratio and equity ratio reliefs may allow for greater deductibility than 30% of EBITDA depending on the circumstances of the group. In the case of a SCWG, the ILR may have no practical effect notwithstanding the company may have excessive borrowing costs where the company is not making payments to an associated enterprise and elects to operate either the group or equity ratio.

An orphan SPV would typically be expected to qualify as a SCWG. As such, the ILR should be of limited if any relevance to such an SPV which is not consolidated for accounting purposes with another entity, does not have related party (i.e. associated enterprise) debt and has made the appropriate ratio election.

There is still some uncertainty around the application of the ILR in Ireland. Clarity will be a gradual process starting with the anticipated publication in the second half of 2022 of relevant guidance from the Revenue Commissioners of Ireland.

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