February 2011

MEMBERS' UPDATE

Tax

Changes to the rules on getting an Irish tax deduction for interest payments

What has happened?

Amid the somewhat chaotic passing of the Finance Act in January 2011, treasurers may have missed a provision that could have significant consequences for the tax deductibility of intra-group interest payments.

When income tax was introduced to Ireland in 1853 one of the main deductions was for interest on borrowings. Originally, all interest payments made by a person or a company were tax deductible. Older readers will recall the days when all mortgage interest could be fully offset against your income tax bill. As with mortgage interest, the tax treatment of the interest that companies pay has been significantly eroded.

In the past these restrictions have tended to focus on non-trading interest (so called, 'interest as a charge' provisions). Treasurers will be familiar with the requirements to obtain an interest deduction where their companies are buying new subsidiaries, for example. (And their rules also changed this year as well – see below.)

However, interest on monies borrowed for trading purposes resulted in no significant tax issues. This view has been supported by the Irish Courts in the *Ringmahon* case (2001). This has now changed with the Finance Act 2011. As would be expected when anyone tries to change over 150 years of tax and commercial practice, the legislation, although short, will have significant unforeseen and complex consequences for all Irish operations and for treasurers in particular. Some clarification has, however, flowed from a Revenue eBrief (11/11) that issued on 15 February.

What do the new rules do?

What the new rules say is that:

- Where you borrow money from a connected company;
- To 'acquire an asset' from a connected company; then
- The interest on those borrowings is not tax deductible.

Companies are connected if one controls the other or both are controlled by the same person. That is a global test.

The eBrief has confirmed that the making of a loan is not the 'acquisition' of an asset.

There are a number of exceptions to these rules:

- the asset being bought is 'trading stock'; The eBrief confirms that for banks or, specifically, treasury companies where its trade, for tax purposes, includes the lending of money, all financial assets will be considered 'trading stock'. As are plant and machinery for leasing companies.
- the asset is certain intellectual property;

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- of particular relevance to treasurers, but probably practically useless, is the exception where the 'sole business' of the connected company making the loan is on-lending to the borrower of funds borrowed from third parties;
- borrowings by 'section 110' securitisation companies;
- assets that are brought for the first time into the Irish tax net, where those assets will be immediately on-leased;
- where a trade was not within the Irish tax net, and as a result of the intra-group acquisition will now be within the Irish tax net; and
- where, according to the eBrief, assets and their related funding are being transferred together within the Irish tax net.

There are complex anti-conduit rules (where, for example, you deposit cash with a bank and that bank then makes the loan, to avoid the internal borrowing restriction), trade streaming rules and restrictions on obtaining a tax deduction for interest in excess of the additional profits brought into Ireland with the new assets or trade (with the excess being lost as a tax deduction).

There are new rules restricting the tax deductibility of non-trading borrowings; for example, on interest where funds borrowed are then used to fund a connected party to acquire assets from connected parties.

Finally, there are also new interest deductibility restrictions where the funds borrowed, from third-parties, are on-lent to non-Irish companies, particularly non-Irish finance companies.

Grandfathering

Loans entered into before 21 January 2011 are grandfathered. Rollovers or refinancing of 'good' loans in the future may not be a problem.

What do treasurers need to do?

In the *Ringmahon* case, one judge said 'the Revenue Commissioners cannot direct a taxpaying company as to how it should finance its business'. That is no longer completely correct.

Previously, cash and assets could be moved around your group with relative ease. No longer. Instead, for example, if company A sells widgets to company B, you will need to check:

- Are companies A and B connected.
- Are widgets trading stock for company B?
- If they are not, how is company B financing the acquisition?
- If company B has any internal borrowings, are you certain that no part of that borrowing was 'used' in acquiring those widgets?

Every new borrowing by a group company from another group company will have to be considered from a tax perspective. In fact, even third party borrowings will be more complicated. Over time, things will settle down to new routines but until then real care needs to be taken by treasurers and you must not assume that what worked in the past will work after 21 January 2011.

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