New Tax Landscape for Irish Property Funds: Finance Act 2016

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Introduction

Finance Act 2016 contained a number of measures in relation to the taxation of certain Irish property-related assets. The intention to introduce such measures was well flagged both before and within the Minister's Budget Speech in October 2016, and the measures were designed to counteract a perceived erosion of the Irish tax base in relation to the holding of such assets.

The measures can be divided into those that impact on s110 TCA 1997 companies and those that impact on Irish regulated funds. This article focuses only on the latter category, i.e. those impacting on Irish regulated funds, and the s110 changes are considered in the article by Séamus Kennedy, "Finance Act 2016 Changes to the Irish Securitisation Tax Regime", in this issue of *Irish Tax Review*.

As an overall comment, the changes themselves are extremely complex and contain a plethora of definitions, new concepts and anti-avoidance measures that are difficult to get to grips with.[1] Based on industry discussions, a considerable number of issues have been identified already, from both a technical and a practical perspective, which remain unclear at the time of writing. This article is obviously a summary of the main impact of the changes and does not address all of these associated issues.

The practical operation of the rules will prove challenging, as a result, for fund administrators and/or other service providers, particularly in the early days of their operation (they are generally effective from 1 January 2017), and more issues are likely to be identified over time once the rules start being implemented. It is anticipated that comprehensive Revenue guidance will issue in due course in relation to these rules.

Tax Regime Applicable to Irish Regulated Funds and Their Investors

It is worthwhile, at the outset, to understand the types of regulated funds that may be impacted by such changes and the tax regime applicable to them.

Ireland is a leading global domicile for regulated funds, in terms of both retail investor funds (referred to in this article as UCITS[2]) and professional investor funds (generally set up as QIAIFs[3]). The tax regime relating to an Irish regulated fund (whether UCITS or QIAIF) and its non-Irish-resident investors has heretofore been quite straightforward. The regulated fund itself is exempt from tax on its income/gains, while a non-Irish-resident investor is exempt from tax on distributions from and disposals/redemptions of units in the fund (subject to certain conditions).

With certain exceptions, an Irish-resident investor will generally suffer an exit tax (or "investment undertakings tax") on distributions from and gains arising from disposals/redemptions of units in the fund at the rate of 41% for an individual investor or 25% for a corporate investor, although the actual

1 Section 23 Finance Act 2016 inserts a new Chapter 1B into Part 27 of TCA 1997 (the new sections being ss739K to 739W) plus a new Schedule 2C.

2 UCITS is the common abbreviation for undertakings for collective investment in transferable securities. UCITS are retail investor funds that are set up in accordance with the EU UCITS Directive and operate freely throughout the EU on the basis of authorisation by a single EU Member State.

3 QIAIF refers to a qualifying investor alternative investment fund, which is an Irish-domiciled fund that can be marketed only to institutional and other sophisticated investors. A QIAIF is not a UCITS fund.

operation of the investment undertakings tax regime can become quite complex for such investors over time.[4]

It is also important to note that the vast majority of Irish regulated funds will not be impacted by the Finance Act 2016 changes, and therefore the basis of taxation for those funds and their investors will remain the same for the following reasons:

- UCITS funds are specifically excluded from the definition of an IREF (Irish real estate fund; see below).
- The measures will impact on a regulated fund only to the extent that the fund meets the definition of an IREF (covered below) – this means that a QIAIF whose holding of Irish property assets represents less than 25% of its overall assets will not be impacted.
- Only a QIAIF that is set up as a corporate (being an investment company or an ICAV[5]) or a unit trust will be impacted by the changes. A QIAIF that is transparent for Irish tax purposes, being either an investment limited partnership or a common contractual fund, is not impacted.
- The QIAIF itself will remain exempt from tax on its income and gains, and IREF status does not impact on that exemption.
- The changes are targeted at investors (mainly non-Irish-resident) that are exempt from investment undertakings tax under the pre-Finance Act 2016 rules. Where an investor is already subject to investment undertakings tax (which will include Irish-resident individuals/most corporates), the classification of the fund as an IREF will not impact on that investor's existing tax position.

New Concepts/Definitions

Finance Act 2016 introduced several new concepts and definitions that are fundamental to understanding the changes impacting on regulated funds.

The most significant concept is that of the Irish real estate fund (IREF). An IREF for these purposes will be a QIAIF[6] in which 25% of the value of its total assets at the end of the prior accounting period is derived directly/indirectly from Irish property assets ("IREF assets"[7]).

Where a fund's holding of IREF assets is below 25%, it may also be regarded as an IREF where "it would be reasonable to consider that the main purpose of the [fund] was to acquire IREF assets or to carry on an IREF business".[8] It should be noted that in the case of an umbrella fund structure the above tests are applied on a sub-fund by sub-fund basis.

Whereas the 25% holding test is obviously straightforward, the second strand of the definition is not, and it remains to be clarified what factors might be relevant in this analysis. This may be an area on which some Revenue guidance will be required. As noted above, the vast majority of Irish regulated funds will fall outside of the definition of an IREF and will therefore not need to be unduly concerned about these changes.

The next fundamental concept is that of the personal portfolio IREF (PPIREF),[9] which is an IREF under the terms of which an investor (or a person connected with the investor) can select or influence the selection of the IREF assets or the business of the IREF. This is predominantly an anti-avoidance measure designed to restrict certain benefits where an IREF is subject to

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4 Due to, for example, the operation of the eight-year deemed-disposal rules etc.

5 ICAV refers to an Irish collective asset-management vehicle.

6 Noting the specific exclusion of UCITS funds from the IREF definition.

7 The definition of "IREF assets" includes Irish land and buildings, shares in unquoted Irish real estate companies, certain Irish real estate loans, and shares in Irish REITs and other IREFs. An "IREF business" means activities involving IREF assets generally but specifically includes activities such as dealing in or developing land and property rental businesses. Both of these definitions are reasonably straightforward.

8 Definition per new s739K TCA 1997.

9 Section 739M TCA 1997.

such influence by its investors, in particular the denial of exemption for the holding of Irish property for more than five years (see below).

The question of PPIREF status is specific to each investor and should be reviewed by each. It is understood that the implied terms (including the actions of the fund), as well as its written terms, will be taken into account in determining whether an IREF is a PPIREF of a particular investor.

The occurrence of an "IREF taxable event" is the charging point for the new IREF withholding tax (covered further below). IREF taxable events include:

- the payment of a distribution,
- the cancellation/redemption/repurchase of IREF units from an investor,
- an IREF ceasing to be an IREF (e.g. by falling below the 25% threshold) and
- the disposal of units by an investor (otherwise than by way of e.g. cancellation/redemption/repurchase of the units).

When Does Withholding Tax Apply and Are There Any Exemptions?

An IREF taxable event will generally give rise to a requirement for the fund to apply a withholding tax at the rate of 20% on the "IREF taxable amount", the computation of which is discussed below. This withholding will apply to all IREF taxable events taking place from 1 January 2017; as discussed below, it **effectively includes any IREF profits that have arisen before 1 January 2017 but that are distributed only on or after that date**.

Broadly, the new withholding will apply on the occurrence of an IREF taxable event in relation to investors that would otherwise be exempt from investment undertakings tax. As noted above, this will generally be non-Irish-resident investors, but there are certain classes of Irish exempt investor that are potentially brought within the scope of the withholding. There are a limited number of exclusions from this, including:

- certain Irish pension funds/PRSAs,
- Irish regulated funds,
- Irish life companies,
- EU pension funds/regulated funds/life companies[10] and
- Irish s110 companies.

With a view to protecting the withholding tax position where the IREF taxable event relates to the disposal of IREF units (other than by way of cancellation/redemption/repurchase of the shares), s739T TCA 1997 introduces a requirement for the purchaser to withhold 20% of the **gross proceeds** and remit that amount to Revenue. This is similar to the existing s980 procedure and seems to apply irrespective of whether the seller is entitled to exemption from IREF withholding or no tax would be due, e.g. where no gain has arisen to the seller.

Although it may be possible for the seller to obtain a refund of any excess tax, this provision is quite onerous and imposes a significant burden on the seller in terms of cash-flow and administration in obtaining a refund. Disposal of units in this manner is therefore best avoided, if possible.

How Do You Calculate the Withholding Amount?

It is worth noting at this stage that gains arising on the disposal of actual real estate (other than development land) that has been held for a period of at least five years will not be part of the IREF profits for the purposes of calculating the withholding amount.[11] This exemption will

10 Provided that such entity is subject to "supervisory and regulatory arrangements at least equivalent" to those applied to similar Irish entities – the parameters of what would constitute equivalence for these purposes will need to be clarified.

11 Certain other items are also excluded from the calculation of IREF profits, including unrealised gains on real estate, dividends from Irish real estate companies (other than a REIT) and profits/gains from a REIT (other than property income dividends from a REIT) – definition of "IREF excluded profits" per s739K TCA 1997.

not, however, apply where the IREF is a PPIREF in respect of the investor (as covered above). The exemption reflects a very clear Government policy objective of encouraging longer-term investment in Irish property and is to be welcomed.

The formula for the calculation of the IREF taxable amount is contained in the new s739L TCA 1997, as follows:

IREF Taxable Amount = A x B/C – D

where

A is the portion of the IREF taxable event that is attributable to the retained profits of the IREF,

B is the retained IREF profits,

C is the retained profits of the IREF and

D is the "purchased" IREF profits not previously distributed by the IREF.

The calculation will need to be done in respect of each investor on the occurrence of an IREF taxable event. It is anticipated that the calculation of the IREF taxable amount may prove quite complex. The main thrust of the computation is that it is only the portion of the overall income on distribution/gain arising to the investor that relates to the IREF profits of the fund to which withholding should apply (i.e. any other profits/gains are excluded through the A x B/C part of the computation).

The computation also seeks to exclude any portion of the undistributed IREF profits that were earned before the investor held the units in the IREF (D in the computation). The calculation would be quite straightforward in the context of, for example, a closed-ended fund with a small number of longer-term investors.

Difficulties will, however, begin to arise once you go beyond that very simple scenario (such as where large numbers of investors are moving in and out of the fund at various times), and it will be a challenge to obtain the appropriate information and complete the computation in a timely manner for such investors.

Can an Investor Reclaim Any Portion of the Withholding Tax?

In short, yes.

An investor resident in a treaty country may reclaim any excess withholding tax down to the rate specified in the terms of the particular treaty. Section 739O TCA 1997 makes provision for such reclaims, effectively by deeming the IREF taxable amount to be a dividend for these purposes.

Section 739O(2), however, restricts the ability of the holder of 10% or more of the units to claim treaty relief and does so in quite a novel way (in the author's view). For holders above this threshold, the IREF taxable amount is treated instead as income from immoveable property, for which relief would not be available in accordance with the terms of our treaties.

Recognising that investors may invest indirectly in an IREF through other entities, the legislation[12] also provides for a reclaim for certain investors who have invested indirectly in the IREF but would have been entitled to exemption had they invested directly, i.e. the investor fits within one of the limited number of exclusions noted above. This will not be available, however, if the IREF could be regarded as a PPIREF of the investor (covered above).

Details of the procedures for reclaims under either of the above provisions have not been published at the time of writing but are expected in due course.

Transition to Other Structures

It is fair to say that the new IREF rules reflect very clearly the desire to reduce the attractiveness of Irish regulated funds as

12 Section 739Q TCA 1997.

vehicles to hold Irish property assets. Given the additional taxation and compliance obligations imposed, it is quite possible that alternative structures will be used to house future Irish property investments. Existing investors may also look to move their portfolios out of regulated fund vehicles, something that is provided for in the legislation.

In line with this, the legislation provides certain reliefs for the transfer of assets from an IREF to an unregulated company[13] or to an Irish real estate investment trust (REIT).[14] We understand that the REIT proposition is potentially of interest to several parties and, again, reflects a clear legislative intention to encourage further REITs to be set up in Ireland.

Conclusion

The new IREF rules are complex, and their operation will impose a significant additional compliance burden on funds and their service providers (including additional documentation requirements from investors, calculation of withholding tax payable and returns to Revenue).

Although there remain a number of areas where clarity through Revenue guidance will be required, added to the fact that the processes for refunds/declarations required from investors have not yet been finalised at the time of writing, the rules are operative since 1 January 2017, which obviously gives rise to challenges to funds in the interim period.

The changes outlined above are clearly hugely significant for those invested in Irish property, but it is important to note that they will have a limited impact in the context of the overall Irish funds regime. As these are very specific, targeted changes, it is hoped that they will not discourage overseas investors from continuing to use Irish fund vehicles for investment in other asset classes.

Read more on taxfind From Irish Tax Institute Direct Tax Acts, Finance Act 2016; *FINAK - Finance Act 2016 Explained*

13 Section 739V TCA 1997 – for transfers before 1 July 2017.
14 Section 739W TCA 1997 – for transfers before 1 January 2018.

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