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Asset Management conference 2016

The changing face of Asset Management

27 September 2016

Changing tax landscape - Section 110

27 September 2016

Billy McMahon
Tax Director
Grant Thornton, Limerick

Introduction

Domestic developments

Section 110 Companies Holding Irish-Property Related Assets

International developments

1. BEPS update
2. EU ATA Directive

Proposed changes to Section 110 – September 2016
The headlines

- ***‘Vulture funds…tax loophole…using charitable status for tax avoidance…’*** (Source: Various publications)
- ***‘Section 110 goes on trial in Ireland’*** (Source: Finance Dublin, September 2016)
- ***‘Fiddling with s.110 could be as bad as fiddling with the 12.5% [rate]’*** (Source: Finance Dublin Editorial, September 2016)

Proposed changes to Section 110 – September 2016
Background

- reaction to news headlines regarding ‘vulture funds’ holding Irish property
- charitable trusts brought into controversy (with incorrect media comment regarding abuse of charitable status tax status)
- emotive issues in Ireland
- changes proposed, to be included in Finance Act 2016 but effective 6 September 2016

Proposed changes to Section 110 – September 2016
‘Separate business’ approach

Straightforward idea in theory

1. identify income/gains arising on ‘specified mortgages’ and treat as separate ‘specified property business’
2. apportion expenses across businesses
3. certain interest payable (where profit participating or > arm’s length) by Irish specified property business will not be deductible for tax purposes (unless paid to certain Irish EU noteholders)
4. tax at 25%
5. job done

Proposed changes to Section 110 – September 2016
‘Separate business’ approach

Myriad of technical issues – selection only over next few slides

1. definition of ‘specified mortgages’
2. grandfathering of existing structures
3. switch-off of old GAAP
4. treatment of Losses
5. anti-avoidance

Some ongoing industry engagement with Dept of Finance/Revenue

Proposed changes to Section 110 – September 2016
Technical issues

1. definition of 'specified mortgage'

- *'any financial asset which derives its value or the greater part of its value…from land in [Ireland]'*
- what is included in separate business and what isn't? No de minimis threshold
- does mere fact that, for example, a loan is secured on Irish real estate mean that it is brought into this definition? What about a performing loan – does it derive its value from the financial health of the borrower?
- when do you test?

Proposed changes to Section 110 – September 2016
Technical issues

2. grandfathering of existing structures

- new rules apply to *'…profits arising from the specified property business…after 6 September 2016'*
- include unrealised gains/losses?
- assuming so, computations of unrealised positions at 6 September 2016 – valuations etc?

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Proposed changes to Section 110 – September 2016
Technical issues

3. switch-off of old GAAP

- potentially big disadvantage (removal of certainty, cannot carry losses back etc)
- transitional measures?
- possible to file a tax return on the basis of two GAAPs for the separate businesses?

Proposed changes to Section 110 – September 2016
Technical issues

4. treatment of losses

- losses forward at 6 September 2016? (Allowed? How do you compute etc?)
- surrender of ongoing losses between separate businesses?
- impact of switch-off of Old GAAP (cannot carry losses back)

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Proposed changes to Section 110 – September 2016
Technical issues

5. anti-avoidance

- double piece of anti-avoidance
- new concept of ‘genuine economic activity’

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Proposed changes to Section 110 – September 2016 Thoughts

- introduces enormous complexity to section 110
- reversal of government policy – remember when we were desperate to
  - move assets off the books (by selling the NAMA portfolios) and/or
  - kick-start the property market (we even had a CGT exemption!)?
- moving of goalposts – creates uncertainty for investors
- impact on other section 110 structures?
- impact on Irish funds?

International developments
(1) Base Erosion and Profit Shifting (BEPS) update

- Base Erosion Profit Shifting (BEPS) – OECD/G20 initiative launched 2013
- aims to create *'a single set of consensus-based international tax rules to protect tax bases while offering increased certainty and predictability to taxpayers'* [OECD explanatory statement]
- action plans - 2 main areas impacting section 110:
  1. treaty abuse (Action Plan 6)
  2. interest deductibility (Action Plan 4)

International developments
(1) BEPS update

Treaty abuse (Action Plan 6)

- various mechanisms put forward to tackle treaty abuse (principal purpose test, limitations on benefits test, anti-conduit rules)
- CIVs versus non-CIVs (section 110s = non-CIVs)
- consultation paper published (March 2016), ongoing
- links with Multilateral Agreement (Action Plan 15)

International developments
(1) BEPS update

Interest deductions (Action Plan 4)

- proposal to limit interest deductions (10-30%), company or group basis
- consultation paper published (July 2016), ongoing
- flexibility on implementation, no indication that Ireland will introduce rules detrimental to section 110s

International developments
(2) EU Anti-Tax Avoidance Directive (ATAD)

- published June 2016
- EU implementation of a number of BEPS action plans
- limit on interest deductions (Action Plan 4) of 10-30%, choice to exclude certain financial undertakings/institutions

VAT

27 September 2016

Jarlath O'Keefe
VAT, Partner
Grant Thornton Ireland

Special Purpose Vehicles (SPVs)
VAT considerations

- activities of an SPV are generally exempt from VAT
- EU VAT legislation provides for an exemption in respect to the management of certain qualifying funds
- first schedule to Irish Consolidated VAT Act 2010 exempts from VAT the management of certain undertakings including a qualifying company for the purposes of Section 110 of the Taxes Consolidation Act
- Irish Revenue has broadly interpreted the meaning of management in line with European Court of Justice (ECJ) case law including SDC (C-2/95) and Abbey National (C-169/04)

VAT considerations

- as the activities of an SPV are regarded as VAT exempt the SPV will not have VAT recovery in its own right
- most of the costs (management/custodian) incurred by the SPV should be VAT exempt
- however, certain local costs such as legal/tax fees charged to the SPV are likely to include VAT. Some services received from outside Ireland will also be subject to VAT
- there is limited potential to recover the VAT on such costs based on EU/non EU split
- potential advantage to set up a VAT group with any related entities to maximise recovery of VAT

Relevant case law

- GfBK case (C-275/11)
  - advisory services to specialist investment fund are part of management services and VAT exempt
  - look to the nature of the service and not the person providing it
  - decision was aimed at assisting smaller investors who did not have in house advisors

Relevant case law

- Fiscale Eenheid NV (X) (C-595/13)
  - confirmed that property fund could be a special investment fund
  - management of fund was VAT exempt
  - management included fees in respect to buy/sell but not day to day management of properties

Student residential accommodation

- use of ICAV's to acquire and develop student residential accommodation
  - term lettings – VAT exempt
  - summer lettings – VAT at 9%
  - commercial lettings – VAT exempt but it may be possible to opt to tax the lettings

Student residential accommodation

- some VAT recovery based on the summer lettings and the commercial lettings subject to an option to tax
- beware of RCT:
  - does not apply where the ICAV grants leases with terms of less than 35 years
  - however if the intention is to sell a commercial unit then RCT applies to all of the construction contracts entered into with contractors

Financial Reporting for SPVs

27 September 2016

Sarah Bradley
Manager
Grant Thornton
T +353 (0)1 6805 675
sarah.bradley@ie.gt.com

Lynda Deane
Associate Director
Grant Thornton
T + 353 (0)1 4332 509
lynda.deane@ie.gt.com

Agenda

- Companies Act 2014
- IFRS 9 – Financial instruments
- IFRS 16 – Leases
- Other developments

Companies Act 2014

- Effective date – 1 June 2015
- 18 month transition period ends 30 November 2016, during which time private companies limited by shares must convert to one of the permitted corporate structures under the new Act.

Company types under the Act

- Private Company Limited by Shares (LTD)
- Designated Activity Company (DAC)
- Unlimited Company (UC)
- Public Limited Company (PLC)
- Guarantee Company (CLG)

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Companies Act 2014
Major changes - summary

- Directors’ compliance statement (section 225 of the Act)
- Audit committee statement (Section 167 of the Act)
- Statement of relevant information (Section 330 of the Act)

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Companies Act 2014
Director compliance statement

- annual statement in the directors report acknowledging that they, as directors, are responsible for securing the company's compliance with its 'relevant obligations' [s225]
  - compliance statement must outline the company’s policies which are, in the opinion of the directors, appropriate to the company meeting their obligations while also recognising the legal obligations of the company

Companies Act 2014
Director compliance statement

- the companies that are required to comply with the requirement to prepare and include a compliance policy statement in the annual director's report are:
  - all Public Limited Companies (PLCs)
  - large private companies - i.e. private companies limited by shares (LTDs), Designated Activity Companies (DACs) and Companies Limited by Guarantee (CLGs) where the balance sheet for the year exceeds €12.5 million and the turnover for the year exceeds €25 million
- any contravention of a director to fulfil their obligation to prepare a Compliance Statement is classed as a category three offence which carries a fine of up to €5,000 or imprisonment not exceeding six months, or both

Companies Act 2014
Director compliance statement

The compliance statement in the directors' report must contain the following:

A statement acknowledging directors responsibility	confirmation that drawing up of the company compliance policy statement has been completed	confirmation that structures are in place that ensure compliance with the company's relevant obligations	confirmation that review of those arrangements or structures is in place to secure compliance

Companies Act 2014
Audit committee statement

- the Act requires companies with a turnover of greater than €50 million and total assets in excess of €25 million
  1. to establish an audit committee and disclose this in the directors' report, or
  2. explain in their directors' report the reasons why they have not done so
- the audit committee must include at least one independent Non-Executive Director (NED) who has 'suitably qualified'
- the statutory auditor is obliged to report to the audit committee on any key matters arising from the statutory audit with particular reference to any material weaknesses in internal controls
- failure for a director to take steps to either set up an audit committee or have reasons for not doing so could result in a fine of up to €5,000 or imprisonment not exceeding six months or both

Companies Act 2014
Audit Committee Statement

Responsibilities of the audit committee:

Monitor the financial reporting process	Monitor the effectiveness of the company's systems of internal control	Monitor the statutory audit	Review and monitor the independence of the statutory auditor

Companies Act 2014
Statement of relevant information

- requirement to include in the directors' report:
  1. that there is no information relevant to the audit of which the statutory auditor is unaware
  2. that all steps have been taken by the director to make himself aware of any relevant audit information and to ensure the statutory auditor is made aware of any such information
- 'relevant audit information' is defined very broadly and is therefore designed to encompass any form of transaction or activity of the company during the financial period

Companies Act 2014
Statement of relevant information

- subsection 330(3) of the Act specifies that a director should make enquiries of fellow directors and the statutory auditor and any other steps necessary to exercise reasonable care, skill and diligence
- should the directors' report is found to be false, this could result in a fine up to €50,000 and a five year term in jail or both
- the inclusion of a statement as to the provision of relevant audit information in the directors' report is mandatory for financial years beginning on or after 1 June 2015

IFRS 9 – key points for implementing IFRS 9

Hedge accounting - recap	• overhaul of hedge accounting compared to IAS 39 • significant improvements by aligning accounting with risk management • improves investors' understanding of the business and risk management activities
Classification of financial assets and liabilities - recap	• Includes: • amortised cost • fair value through other comprehensive income • fair value through profit or loss.
Impairment/expected credit loss – latest guidance	• applies to all debt-type assets that are not measured at fair value through profit or loss. • uses more forward-looking information to recognise expected credit losses for all debt-type financial assets that are not measured at fair value through profit or loss.

IFRS 9
Classification of financial assets and liabilities

- IFRS 9 classifies financial assets into three main measurement categories:
  - amortised cost
  - fair value through other comprehensive income
  - fair value through profit or loss.
- IFRS 9 contains options to designate:
  - equity investments at fair value through other comprehensive income
  - a financial asset at fair value through profit or loss in some circumstances
- both of these options are only available on the initial recognition of a financial asset.

IFRS 9
Classification of financial assets and liabilities

- the basic classifications for a financial liability are:
  - amortised cost
  - fair value through profit or loss.
- financial liabilities accounted for at fair value through profit or loss fall into two categories:
  - financial liabilities held for trading
  - financial liabilities designated at fair value through profit or loss on inception.

IFRS 9
Impairment – expected loss

- IFRS 9’s impairment requirements apply to all debt-type assets that are not measured at fair value through profit or loss
- IFRS 9 uses more forward-looking information to recognise expected credit losses for all debt-type financial assets that are not measured at fair value through profit or loss. This is a major change from the previous Standard, IAS 39
- investments in equity instruments are outside the scope of the impairment requirements as they are measured at fair value
- unlike IAS 39, it is not possible under IFRS 9 to measure investments in equity instruments at cost where they do not have a quoted market price and their fair value cannot be reliably measured

IFRS 9
Impairment – expected loss

- one consequence is that a credit loss arises as soon as a company buys or originates a loan or receivable – a so-called ‘day one loss’.
- therefore now an entity always estimates an ‘expected loss’ considering a broader range of information, including:
  - past events, such as experience of historical losses for similar financial instruments
  - current conditions
  - reasonable and supportable forecasts that affect the expected collectability of the future cash flows

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IFRS 9
Impairment – expected loss

- IFRS 9 (2014) requires an entity to recognise a loss allowance for expected credit losses on the following:

- debt instruments measured at amortised cost
- debt instruments measured at fair value through other comprehensive income
- lease receivables
- contract assets (as defined in IFRS 15)
- loan commitments that are not measured at fair value through profit or loss
- financial guarantee contracts (except insurance contracts).

IFRS 9
Impairment – presentation

- for financial assets measured at amortised cost in the statement of financial position, the loss allowance reduces the net carrying amount of the asset
- the measurement of debt-type financial assets classified at Fair Value through Other Comprehensive Income (FVOCI) is a combination of both amortised cost and fair value measurement. Because such assets are measured in the statement of financial position at fair value, the expected credit losses recognised under IFRS 9 do not reduce the carrying amount of the financial assets in the statement of financial position. Instead an accumulated impairment amount is recognised in other comprehensive income

IFRS 9
Impairment – presentation

- IFRS 9 introduced a consequential amendment to IAS 1 ‘Presentation of Financial Statements’ which requires impairment losses to be shown as a separate line item in the statement of profit or loss
- no similar amendment was made in respect of the statement of financial position, but an entity should however give consideration to IAS 1’s general requirement to present additional line items when this is relevant to an understanding of the entity’s financial position

IFRS 16 - Leases

Purpose

- remove “off balance sheet” accounting
- replaces IAS 17
- narrows split between operating and finance leases

Impact

- scope out – non-generative resources; biological assets; service concession arrangements; IP; licencing arrangements
- requires lessees to account for leases ‘on-balance sheet’
- lessor accounting is largely unchanged

Effective date

- annual periods beginning on or after 1 January 2019
- early application is permitted (providing IFRS 15 ‘Revenue from Contracts with Customers’ is applied

IFRS 16 - Leases
Change in definition

Lease definition

- Under IFRS 16 a lease is defined as: ‘a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration’.
- a contract can be (or contain) a lease only if the underlying asset is ‘identified’.
- having the right to control the use of the identified asset requires having the right to:
- i) obtain all of the economic benefits from use of the identified asset
- ii) direct the use of the identified asset.

Impact

- on contracts not in the legal form of a lease but involve the use of a specific asset and therefore might contain a lease
- e.g. outsourcing, contract manufacturing, transportation and power supply agreements.
- this evaluation was based on IFRIC 4, but now IFRS 16 replaces IFRIC 4 with new guidance that differs in some important respects.

IFRS 16 – Leases
Accounting by lessees – Initial recognition

Right-of-use asset		Lease liability
Lease liability		<u>Lease payments</u> Discount rate
Lease payments made before, or at, commencement date		
Restoration costs		Provision
Initial direct costs		

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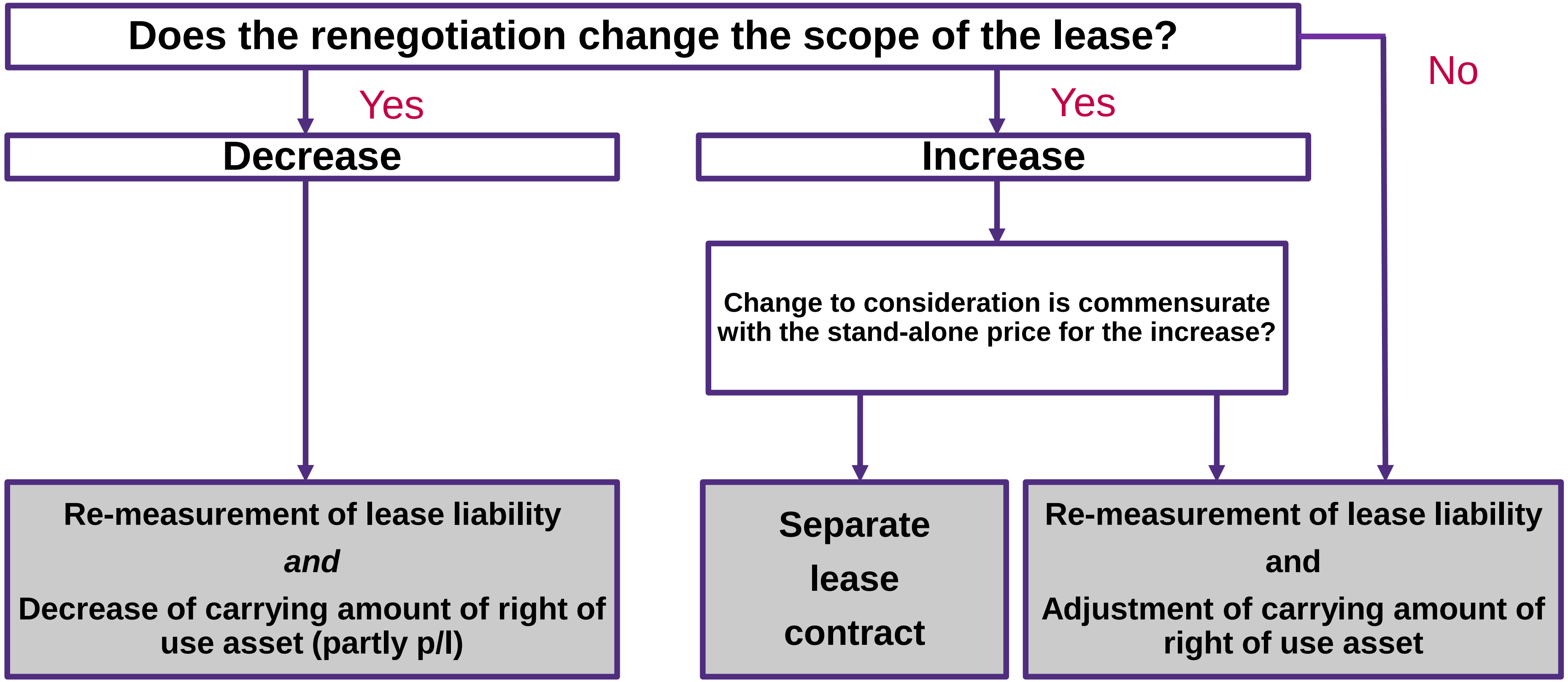
IFRS 16 – Leases
Accounting by lessees – Subsequent accounting

	Right-of-use asset	
Subsequent	Cost <u>unless</u> Investment property – FV (IAS 40) Elect to apply revaluation model (IAS 16)	Effective interest rate method
Reassessment		• Change in lease term • Exercise price of a purchase option • Change in amounts expected to be paid • Change in index/rate

IFRS 16 – Leases
Accounting by lessees – Modification of a lease



IFRS 16 - Leases
Presentation

SOFP

- right-of-use asset presented either separately or in the same line item in which the underlying asset would be presented
- lease liability presented either as a separate line item or together with other financial liabilities
- if not shown separately on the face of the SOFP – must disclose in the notes

SOPLOCI

- amortisation charge presented in the same line item as similar expenses
- interest expense on the lease liability is presented as part of finance costs (but must be disclosed in the notes)

SOCF

- lease payments are classified with payments on other financial liabilities
- principal portion of lease liability = financing activities
- interest portion of lease liability = operating or financing activities (depending on entity policy)

IFRS 16 - Leases
Disclosure

Right of use asset
Amortisation charge (by class)
Carrying amount (by class)
Additions

Lease liabilities
Interest expense
Maturity analysis

Recognition and measurement exemptions

Other disclosures relating to the Income Statement
Expense relating to variable lease payments not included in lease liabilities
Income from sub leasing right of use assets
Gains/losses arising from sale and leaseback transactions

Qualitative
Nature of the lessees leasing activities
Restrictions or covenants imposed by the lessee
Sale and leaseback transactions

Future cash outflows from…
Variable lease payments
Residual value guarantees
Extension options and termination options
Leases not yet commenced to which the entity is committed
Short term lease commitments

IFRS 16 – Leases
Sale and leaseback changes

Overview

- IFRS 16 makes significant changes to sale and leaseback accounting.
- if an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from the buyer-lessor, both the seller-lessee and the buyer-lessor determine whether the transfer qualifies as a sale.
- this determination is based on the requirements for satisfying a performance obligation in IFRS 15.

If the transfer qualifies as a sale and the transaction is on market terms the seller-lessee effectively splits the previous carrying amount of the underlying asset into:

- a right-of-use asset arising from the leaseback
- the rights retained in the underlying asset by the buyer-lessor at the end of the leaseback.

If the transfer does not qualify as a sale the parties account for it as a financing transaction. This means that:

- the seller-lessee continues to recognise the asset and accounts for the amounts received as a financial liability
- the buyer-lessor does not recognise the transferred asset and accounts for the amounts paid as a financial asset

IFRS 16 – Leases
Transition

IFRS 16 provides lessees with a choice between two transition methods:

- **full retrospective application** – with restatement of comparative information in accordance with IAS8
- **partial retrospective application** – without restating comparatives. Under this approach the cumulative effect of initially applying IFRS 16 is recognised as an adjustment to equity at the date of initial application

IFRS 15 – Revenue from contracts with customers

- Core principle
- 5 Steps to achieve core principle
- Disclosure
- Transition

Conceptual framework – Exposure draft May 2015

- Why? Fill gaps, update, clarify
- Revised definitions of assets and liabilities
- Disclosure
- Transition

Questions & feedback

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