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## Acquisition and Disposal of Distressed International Debt Through Ireland – updated for Finance Act 2011

### Structuring

Current market conditions have given rise to significant opportunities in acquiring distressed debt internationally. Much of this debt has been lent for property acquisitions from Irish and other financial institutions. A combination of factors, including the effect of the economic downturn on borrowers' ability to repay debts and pressure on financial institutions to manage their balance sheets, has led to loan portfolios being traded at a discount to their face value.

Ireland's tax regime provides several options for tax efficient investment in distressed assets on a global scale. The purpose of this note is to explore some of the structures which may be used for investment in financial assets, including loan portfolios, and the associated tax advantages.

The appropriate structure for each transaction will depend on the particular facts of the case and will be influenced by factors such as the asset portfolio to be acquired, pre-existing liabilities of the vendor and the perceived value of the target or its portfolio.

Ireland offers a variety of investment vehicles which have proven popular in international transactions due to the flexibility of the legal and regulatory regime and favourable tax environment. Set out below is a summary of vehicles used as distressed debt investment vehicles:

1. Use of corporate vehicle;
2. Special purpose companies qualifying for specific tax treatment under section 110 Taxes Consolidation Act ("TCA"), 1997 ("SPCs");
3. Irish regulated fund structures;
4. Structures involving a combination of an Irish regulated fund and a SPC;
5. M&A of sub-prime mortgage business using Ireland as an EU hub.

#### *i. Use of Corporate Vehicle*

A company incorporated and tax resident in Ireland is liable to tax at 12.5% on trading income and 25% on other income. Capital gains are chargeable at 25%. The scope of Irish tax is further limited where transactions are structured through a non Irish resident corporate with an Irish branch. For example, it is common to use a Luxembourg incorporated entity with an Irish branch to structure transactions through Ireland.

Where an Irish tax resident corporate is used to acquire distressed debt, the question arises as to whether or not it is regarded as trading in Ireland and the margin, if any, taxable in Ireland. Unless there are substantive operations in Ireland, then an Irish tax resident corporate may be liable to tax at 25% on any profit. Entities taxable at 12.5% will be subject to Ireland's new transfer pricing rules. It is for this reason that Irish Section 110 vehicles are prevalent.



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## ii. Section 110 TCA 1997 Corporates

Special tax treatment is afforded under Irish law to Irish tax resident SPC's investing in qualifying financial assets. In summary, an Irish tax resident company may elect under Section 110 TCA 1997 to have expenses, including interest, discount, premium and profit participating returns that would not otherwise be deductible set against its income so that effectively, the profit subject to Irish tax at 25% is negligible. Such an entity is nonetheless entitled to benefit from Ireland's tax treaties. Finance Act 2011 has expanded the assets which may be securitised and restricted the deduction for interest payments made under profit participating loan arrangements.

Section 110(2)(b) TCA 1997 provides –

*“there shall be deducted, in computing the amount of the profits or gains to be charged to tax, the amount, in so far as it is not –*

*(i) otherwise deductible, or*

*(ii) recoverable from any other person or under any insurance, contract of indemnity or otherwise,*

*of any debt which is proved to be bad and of a doubtful debt to the extent that it is estimated to be bad.”*

Effectively, this provision means that a profit participating return, or other amount that reduces a corporate's profits, shall be treated as deductible, subject to the new Finance Act 2011 restrictions.

Finance Act 2011 restricts the deduction for profit participating interest payments to circumstances where the interest is paid;

- i) to a person who is tax resident in Ireland,
- ii) to a pension fund, government body or other tax exempt person resident for tax purposes in a Member State of the European Communities or a jurisdiction which has a double tax treaty having force of law with Ireland, or on completion of the procedures, will have force of law in Ireland (i.e. a “Relevant Territory”),
- iii) to a person resident for tax in a Relevant Territory which generally applies tax to foreign source profits, income or gains (without a reduction calculated based on the amount of the payment),
- iv) on either a Quoted Eurobond or a Wholesale Debt Instrument, or
- v) the interest payment has been subject to Irish withholding tax.

The proposed changes do not impact existing arrangements in place as at 21 January 2011.

To make the necessary election, the following conditions must be met:

- the company must be in the business of holding, managing, or both the holding and management of financial assets and must not carry out any other activities apart from activities which are ancillary to that;
- the company must be Irish tax resident;
- the market value of all qualifying assets held or managed must not be less than €10,000,000 on the day on which the assets are first acquired or first held (as this is a point in time test of the gross assets of the company it is possible to borrow to meet this threshold);
- the transactions carried out by the company must be at arm's length; and
- the company must file a form with the Irish Revenue Commissioners electing to be treated as an SPC. The Irish Revenue Commissioners have no discretion to refuse an election where the conditions are met.



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A qualifying asset means an asset which consists of, or of an interest in,

- (i) a financial asset,
- (ii) commodities, or
- (iii) plant and machinery.

A financial asset is also defined in the legislation. The definition is extensive and has been updated consistently to include:

- *shares, bonds and other securities,*
- *futures, options, swaps, derivatives and similar instruments,*
- *invoices and all types of receivables, obligations evidencing debt (including loans and deposits),*
- *leases and loan and lease portfolios,*
- *hire purchase contracts,*
- *acceptance credits and all other documents of title relating to the movement of goods,*
- *bills of exchange, commercial paper, promissory notes and all other kinds of negotiable or transferable instruments,*
- *carbon offsets, and*
- *contracts for insurance and contracts for reinsurance.*

Commodities means tangible assets (other than currency, securities, debts or other assets of a financial nature) which are dealt in on a recognised commodity exchange.

Typically, a SPC is funded primarily by debt. It raises funds through the issue of profit participating loan notes and uses these funds to purchase financial assets e.g. mortgage receivables from an originator (usually a financial institution). This enables the originator to raise funds in respect of the receivables without incurring a liability.

Investors receive their return on investment as interest or discount arising on a debt. In some cases hybrid instruments may be appropriate which would be regarded as debt in Ireland and equity investment in the investor's jurisdiction of residence. The investment return is funded directly by the receivables held by the SPC. The process allows the originator to convert the income stream into cash in a cost effective manner. It also allows banks or building societies to remove blocks of assets from their balance sheets.

An advantage of Irish SPCs is that no withholding tax arises on payments of interest made by the SPC to investors who are resident in the EU or countries with which Ireland has executed a double tax agreement. If the debt is structured as an issue of quoted Eurobonds it is possible to avoid Irish withholding tax on payments of interest to investors in non-treaty countries also. The issue and transfer of securities issued by a SPC is also exempt from stamp duty.

Ireland has signed double tax agreements with 62 countries (54 of which are in effect) and is constantly expanding its treaty network. The existence of a double tax agreement provides significant advantages when structuring investment internationally. The double tax agreement usually provides for reduced or no withholding tax on payments of dividends, interest and royalties between the two contracting states.

If a company qualifies as a SPC, it is taxed on its net profits as shown in its financial statements at a rate of 25%. The primary advantage afforded to qualifying SPCs is that deductions are allowed for expenses, including interest expenses, as if the SPC were a trading company. This enables transactions to be structured so that only a nominal amount of profit is left in the company and the vehicle remains almost tax neutral. As Ireland does not have thin capitalisation rules setting minimum profit or debt to equity ratio for companies, full interest deductibility is guaranteed within the SPC.

The management of Irish SPCs is VAT exempt irrespective of the type of assets owned by the SPC.

## Tax Department

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### iii. Debt Acquisition through an Irish Regulated Fund

Another tax efficient method of investment in debt assets is through an Irish regulated tax exempt fund structure. Irish regulated funds fall into two categories:

- Undertakings for Collective Investment in Transferable Securities (“UCITS”) – which are collective investment undertakings complying with the requirements and restrictions set out in the EU “UCITS Directive”. Once authorised under this scheme, UCITS can be sold cross border into all other EU member states without the requirement to be specifically authorised in each jurisdiction; and
- Non-UCITS – this term covers all Irish regulated funds that do not fall within the definition of UCITS.

All Irish regulated funds (“funds”) (both UCITS and non-UCITS) are subject to the same tax treatment regardless of whether they are structured as an investment company or a unit trust once they qualify as investment undertakings under Irish legislation. The main tax benefits of such a structure can be summarised as follows:

- No Irish tax arises on income and gains realised from investments within the fund. All income earned and gains arising on the assets of the fund can accumulate within the fund tax free.
- No Irish withholding tax applies to distributions paid to unitholders on any encashment, redemption, cancellation or transfer of units in respect of unitholders who are neither Irish resident nor ordinarily resident in Ireland or exempt Irish investors (e.g. charities, approved pension schemes etc) provided an appropriate declaration has been made. Finance Act 2010 introduced simplification measures enabling funds to dispense with the requirement to obtain non-resident declarations where the fund is not actively promoted within Ireland and certain other conditions are met.
- No Irish stamp duty arises on the issue, transfer, purchase, repurchase or redemption of units in a fund.

UCITS are generally not appropriate vehicles for investment in distressed assets as they are subject to various investment and borrowing restrictions e.g. they cannot invest directly in real estate. Non-UCITS provide increased flexibility in relation to leverage, diversification and investments.

The non-UCITS Qualifying Investor Fund (“QIF”) is the most flexible regulated fund product available. It is one of Ireland’s most popular fund structures and, due to its flexibility, is often the most suitable vehicle for distressed asset investment. As investment in the QIF is limited to high net worth individuals and institutional investors it is not restricted as to the asset classes it can invest in, there are no borrowing limits and very few investment restrictions. There is a minimum subscription of €100,000 and units may only be offered to the following “qualifying investors”:

- an investor who is a professional client within the meaning of Annex II of Directive 2004/39/EC (Markets in Financial Instruments Directive) (“MiFID”); or
- an investor who receives an appraisal from an EU credit institution, a MiFID firm or a UCITS management company, that the investor has the appropriate expertise, experience and knowledge to adequately understand the investment in the scheme; or
- an investor who certifies that they are an informed investor by providing the following:
  - confirmation (in writing) that the investor has such knowledge of and experience in financial and business matters as would enable the investor to properly evaluate the merits and risks of the prospective investment; or
  - confirmation (in writing) that the investor’s business involves, whether for its own account or the account of others, the management, acquisition or disposal of property of the same kind as the property of the scheme.

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The QIF offers significant flexibility within a regulated environment. It can be established as an investment company, unit trust, investment limited partnership or common contractual fund. The Irish Central Bank offers a fast track authorisation procedure for QIFs allowing authorisation within 24 hours.

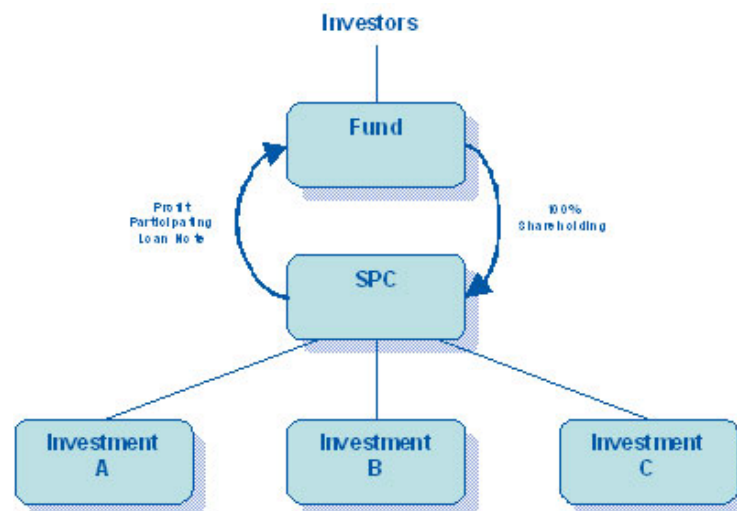
### iv. Debt Acquisition through an Irish Regulated Fund holding its investment through a Section 110 Vehicle

Depending on the nature and location of the investment, there are various characteristics of each structure that may appeal to investors in different locations. For example,

- Some investors may favour equity investment (consistent with investment in a QIF) over debt investment (typical SPC investment).
- There may be uncertainty as to the entitlement of a QIF to benefit from some of Ireland's double tax agreements. Treaty access depends on whether an entity falls within the definition of a "resident" of Ireland as defined in the double tax agreements. Some double tax agreements require an entity to be "liable to tax" in Ireland in order to be regarded as Irish resident for treaty purposes. Due to the fact that a QIF is an exempt entity under Irish law, there is some uncertainty in relation to its entitlement to benefit from double tax agreements which apply the "liable to tax" test. This can lead to withholding tax leakage in jurisdictions in which the underlying debt investment is located.

This can be avoided by combining the benefits of the QIF and the SPC in order to create a two tier investment vehicle with tax efficient cash flows at each level. This is achieved by incorporating a SPC as a wholly owned subsidiary of the QIF. Often the SPC will be a Section 110 vehicle (see ii. above). Full treaty access is enjoyed by the SPC minimising withholding tax on payments into the vehicle. No withholding tax arises on payment from the SPC to the QIF and the QIF can accumulate income received free from Irish tax. No withholding tax arises on distributions or redemptions by the QIF to investors who are neither Irish resident nor ordinarily resident in Ireland.

An example in diagrammatic form is set out below:



### v. M&A of Sub-Prime Mortgage Business

With the constant demands of regulators requiring increased capital adequacy, many financial institutions have curtailed international expansion plans. The acquisition of a distressed sub-prime mortgage platform may provide a means of entering new markets at an attractive entry level. The structured acquisition of such a platform may involve the acquisition of an EU regulated business. Such acquisitions may provide a means of entering the EU market as regulation in Ireland should passport its service offering into other Member States.

## Stamp Duty on Acquisition of Debt

A charge to Irish stamp (transfer) duty of up to 6% needs to be avoided on the acquisition of debt. Subject to various exceptions, stamp duty will apply where:

- the document effecting the transfer is executed in Ireland;
- the debt is deemed to be Irish situate property; or
- the transfer relates to any matter or thing to be done in the State.

As a result, where the debt in question is not Irish situate, no liability to Irish stamp duty should arise on the acquisition, provided care is taken not to execute the instrument of transfer in Ireland or otherwise bring the transaction within the charge to Irish stamp duty. The situs of a debt for Irish stamp duty purposes is governed by the general provisions of Irish law. For example, a simple debt is generally deemed to be situate where the debtor resides, whereas speciality debts and bearer debts are situate where the instrument is physically located.

Where a debt is transferred without the execution of a formal document of transfer e.g. the transfer by delivery of a bearer instrument, no liability to stamp duty arises provided there is no written document evidencing the transfer.

Alternatively, the transfer may be effected by way of novation of the debt as opposed to an assignment. This involves the execution of a tripartite agreement by the original lender, the borrower and the party acquiring the debt. As a novation does not act as a conveyance on sale for stamp duty purposes, the transaction is not within the charge to stamp duty. The suitability of this option will depend on the facts of the transaction, for example, it would not normally be an appropriate means of transferring a large portfolio of debts as it would require execution by each individual debtor.

There are a number of exemptions which may apply, including:

- **Mortgages:** Finance Act 2007 abolished stamp duty on the creation or transfer of mortgages and charges executed on after 7 December 2006.
- **Loan capital exemption:** Loan capital is defined as *“any debenture stock, bonds or funded debt, by whatever name known, or any capital raised which is borrowed or has the character of borrowed money, whether in the form of stock or in any other form”*. The transfer of loan capital of a company or body corporate is exempt from stamp duty provided certain conditions are met. Broadly, the loan capital must not carry a right of conversion into shares of an Irish company, must not carry rights similar to rights attaching to shares (e.g. voting rights, right to profits etc), must not be issued for a price which is less than 90% of its nominal value and must not carry a right to interest which is related to movements in an index.
- **Debt factoring exemption:** A debt factoring agreement is defined as *“an agreement for the sale, or a transfer on sale, of a debt or part of a debt where such sale occurs in the ordinary course of the business of the vendor or the purchaser”*. Stamp duty is not chargeable on a debt factoring agreement provided the instrument does not relate to Irish land or buildings or to shares of a company (other than a collective investment undertaking) which is registered in Ireland. Due to the wide definition applied by the legislation, most transactions involving the purchase of debt from a bank should come within the meaning of a debt factoring agreement.
- **Foreign loan security exemption:** Foreign loan security is defined as *“a security issued outside the State in respect of a loan which is expressed in a currency other than the currency of the State and is neither offered for subscription in the State nor offered for subscription with a view to an offer for sale in the State of securities in respect of the loan”*. Stamp duty is not chargeable on the transfer of foreign loan securities issued by an Irish company.

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## Summary

With a surge in interest in acquiring debt, the question arises as to the mechanism to acquire the debt free of transfer taxes and ensure that any profit on sale is capable of extraction in a tax-efficient manner. This note highlights opportunities for structuring cross-border transactions through Irish vehicles. Ireland is absolutely committed to its 12.5% tax rate and through various tax-efficient investment vehicles, has established itself as a centre for structuring effective investment in distressed assets.