Group Briefing

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Property Investment Structures in Ireland: *Irish Investment Opportunities*

In recent times there has been a welcome return to activity in the Irish real estate market. Overseas investors have been circling and private equity groups have started investing heavily in Irish real estate amid confidence that the Irish economy has stabilised and is returning to growth.

In this briefing we explore some of the tax measures which have been introduced in Ireland, including the opportunities that Irish vehicles can offer to international investors in Irish and non-Irish real estate and mortgage-backed loans.

TAXATION OF IRISH REAL ESTATE: THE BASICS

Like many jurisdictions Ireland levies tax on the acquisition of Irish real estate (stamp duty and potentially VAT), on rental income derived from Irish real estate (income tax / corporation tax and potentially VAT), and on the disposal of Irish real estate (capital gains tax) including by way of gift or inheritance (capital acquisitions tax). Local property tax has also been introduced on residential property in Ireland.

Stamp duty on the acquisition of Irish real estate applied at rates of up to 9% during the heady days of the Celtic Tiger but has since been reduced to 2% in respect of commercial (non-residential property), and 1% in respect of residential property where the consideration is up to €1 million, and 2% on the balance over €1 million.

Rental income derived from Irish real estate is subject to Irish income tax at marginal rates (20% or 41% (reduced to 40% from 1 January 2015) depending on the level of income) for individual investors. They may also be liable for pay related social insurance (PRSI) and the universal social charge, although exemptions may apply in the case of non-Irish resident individuals.

Irish resident companies are subject to Irish corporation tax at 25% on rental income. In addition, in the case of a closely held Irish resident company, a 20% surcharge applies in respect of rental income held by the company which is not distributed within 18 months of the end of the accounting period in which the income arises. In contrast, non-Irish resident companies are subject to Irish income tax at 20% on Irish rental income and the close company surcharge on undistributed rental income does not apply.

Various deductions are available in computing taxable rental income for Irish tax purposes. These include interest on borrowings to purchase or develop real estate, although deductible interest on borrowings in respect of residential property is restricted to 75% of the interest.

Any gain on the sale of Irish real estate is subject to Irish capital gains tax (CGT) which currently applies at the rate of 33%. Ireland levies CGT on gains arising on the disposal of Irish land irrespective of the tax residence of the person making the disposal. The CGT charge also applies to the sale of shares in a real estate owning company where the shares derive more than 50% of their value from Irish land. Ireland has however a limited 'CGT holiday' which exempts from CGT any gain realised on the sale of real estate purchased between 7 December 2011 and 31 December 2014 and held for at least 7 years. Partial relief is available if the property is held for more than 7 years with any gain relieved by the proportion that 7 years bears to the total period of ownership. For example, if property is sold after 10 years, 7/10ths of any gain would be exempt from CGT. Unfortunately, this relief is not being extended to acquisitions made after 31 December 2014.

VAT at 13.5% may be chargeable on the purchase of Irish real estate, and may also be chargeable on rental income on non-residential property (at the standard rate, currently 23%) where an election is made. However, VAT on real estate is a complex area and the VAT position will differ depending on the nature of the property (residential or non-residential property, freehold or leasehold), whether developed or undeveloped, when it was acquired or developed, whether VAT was recovered on its acquisition or development and other factors. In general, VAT is not chargeable on the purchase of Irish residential real estate, or on the purchase of non-residential real estate which has not been developed within the last 5 years. However, exceptions apply and the VAT on property position should be carefully considered in each case. Where VAT is chargeable, it may not be an actual cost to the purchaser (on acquisition) or tenant (in a letting) where the property is used for VATable purposes (e.g. letting to a retail tenant who will pay VAT on the rent). VAT requisitions raised in the context of the purchase of Irish real estate will help to establish the VAT treatment of an acquisition. In addition, where a property is within the VAT net and VAT is recovered, ongoing VAT obligations may also apply to monitor the use of the property and VAT adjustments may apply.

Finally, Irish capital acquisitions tax (CAT) applies at 33% to gifts and inheritances of Irish real estate although various exemptions apply, such as transfers between spouses.

REAL ESTATE INVESTMENT STRUCTURES

While the reduction in stamp duty rates and the 'CGT holiday' are positive measures, the above shopping-list of taxes may dampen the enthusiasm of prospective investors in Irish real estate. However, a number of structures are available to mitigate or indeed eliminate the Irish tax burden.

NON-IRISH RESIDENT COMPANY

For non-resident investors the traditional structure is to invest in Irish real estate through a non-resident company and thereby reduce the Irish income tax liability to 20% of taxable rental income. A CGT charge would still apply to any gain realised on the disposal of Irish real estate although the 'CGT holiday' would be available if the property is acquired between between 7 December 2011 and 31 December 2014 and held for at least 7 years. Any charge to Irish CAT is also avoided for gifts or inheritances between non-residents of shares in a non-Irish incorporated company owning Irish real estate where the person transferring the shares is not, and has never been, Irish domiciled.

Rent paid to a non-Irish resident landlord is subject to 20% withholding tax which must be deducted by the tenant and remitted to the Irish Revenue. The tax withheld can be claimed by the landlord as a credit against its Irish income tax liability, with any excess credit available for refund from the Irish Revenue. However, the requirement to withhold does not apply where rent is paid to an Irish agent of the non-resident landlord, such as a rent collection agent. The non-resident landlord is assessable to Irish tax in the name of the Irish agent. However, any remittances of rent by the agent to the non-resident landlord are not subject to withholding tax. This arrangement can improve the cashflow position for the non-resident landlord without prejudicing its Irish tax obligations.

REGULATED REAL ESTATE FUNDS

The charge to Irish income tax on rental income and CGT on the disposal of Irish real estate can be eliminated altogether where Irish real estate is held through an Irish regulated fund. Ireland offers a range of regulated real estate fund structures with differing levels of investment and borrowing restrictions, minimum subscription requirements and authorisation timeframes depending on the proposed portfolio composition and investor type. The most flexible and optimal vehicle for 'professional investors' in Irish real estate is the Irish Qualifying Investor Alternative Investment Fund (QIAIF).

The Irish QIAIF is a regulated, specialist investment fund. It requires a minimum subscription per investor of €100,000 (or its equivalent) and only certain investors qualify (principally, sophisticated and institutional investors). Irish QIAIFs are subject to minimal investment restrictions and there is no limit on the degree of leverage employed by it, subject to satisfying certain disclosure and counterparty requirements. As a result, the Irish QIAIF has much flexibility in terms of its investments and gearing.

The Irish QIAIF is a tax exempt vehicle and is exempt from Irish tax on income and gains regardless of where its investors are resident. The exemption includes the Irish CGT charge which (ignoring the limited 'CGT holiday' outlined above) would otherwise apply on the sale of Irish real estate or shares in a company deriving its value from Irish real estate. In addition, no withholding or exit taxes apply on income distributions or redemption payments made by an Irish QIAIF to non-Irish resident investors. As a result, the Irish QIAIF is an exceptionally efficient real estate holding vehicle.

IRISH REITS

Irish Real Estate Investment Trusts (REITs) were introduced in 2013. REITs offer a modern collective investment ownership structure for Irish and international investors in the Irish and overseas property markets.

Provided that various conditions as to diversification, leverage restrictions and income distribution are met, the REIT is exempt from Irish corporation tax on income and gains arising from its property rental business as well as Deposit Interest Retention Tax (DIRT). Investors in a REIT are liable to Irish tax on distributions from the REIT. In the case of non-Irish resident investors, income distributions from the REIT are subject to 20% dividend withholding tax which must be withheld by the REIT whether or not the investor is resident in a double tax treaty jurisdiction. This differs from the position, for example, in respect of treaty resident investors in normal Irish resident companies where various dividend withholding tax exemptions are available. However, it is the trade-off for the REIT's tax exempt status on property rental income. Certain non-residents may also be entitled to recover some of the tax withheld on distributions from the REIT or otherwise should be able to claim credit against taxes in their home jurisdictions. Non-resident pension funds may also be eligible for exemption.

In order to qualify for the beneficial REIT tax regime, a REIT must satisfy the following conditions:

- it must be an Irish incorporated and tax resident company;
- its shares must be listed on the main market of a recognised stock exchange in an EU Member State;
- it must not be a closely held company (unless it is under the control of "*qualifying investors*", broadly Irish regulated funds, Irish insurance companies, tax exempt pension schemes or the National Asset Management Agency of Ireland (NAMA));
- at least 75% of the aggregate income of the REIT must derive from a property (real estate) rental business and at least 75% of the aggregate market value of the assets of the REIT must relate to assets of the property rental business (which include proceeds of a disposal of real estate made by the REIT within the previous 2 years);
- the property rental business of the REIT must comprise at least 3 properties, and the market value of no one property must exceed 40% of the market value of the total portfolio;
- the REIT must maintain a ratio of at least 1.25:1 of property income (before property financing costs) to property financing costs, and a loan-to-value (LTV) ratio below 50%; and
- subject to Irish company law requirements, the REIT must distribute by way of dividend at least 85% of its property rental income for each accounting period.

Modelled loosely on the UK REIT legislation, the Irish REIT regime seeks to address some of the difficulties encountered by UK REITs in seeking to meet diversification and listing requirements. A 3 year 'grace period' is available to Irish REITs for meeting these requirements. In addition, the requirement for a REIT to distribute 85% of its rental property income is lower than the UK equivalent (90%) and provides flexibility to deal with re-investment and refurbishment in the portfolio. The 50% LTV debt cap does not apply in the UK REIT regime but has been introduced in addition to the interest to finance cost ratio (which is in the UK regime) to provide stability to investors and reduce the potential for overleverage in the REIT.

The introduction of Irish REITs is a positive and timely development as investors and promoters look to new ways to access and structure real estate investment opportunities. REITs may also be looked at by banks and other financial institutions as potential deleveraging structures rather than straight portfolio sales.

SECTION 110 SPVS AND LOAN PORTFOLIO ACQUISITIONS

As an alternative to the direct acquisition of Irish real estate, the acquisition of loan portfolios has been a principal feature of the response to the recent global financial crisis as banks and financial institutions are required to deleverage and meet increasing capital requirements. Private equity investors have been the main buyers and their experience in Ireland has shown that Ireland offers not only a pool of potential investment opportunities, but also an extremely favourable regime within which to structure an acquisition.

The key Irish vehicle in this context is the Irish Section 110 SPV. Section 110 of the Taxes Consolidation Act, 1997 provides a favourable tax regime for structured finance transactions which has been widely used for many years and applies to a company (a Section 110 SPV) engaged in the holding or management of a wide variety of financial assets such as debt, share portfolios and all types of receivables. While subject to the higher 25% Irish corporation tax rate, the taxable profits of a Section 110 SPV are computed in accordance with trading principles and can include a deduction for profit participating debt. This means that, after deduction of financing costs and other related expenditure as well as interest on profit participating debt, minimal profits are generally left behind in the SPV resulting in nominal taxes. The use of profit participating debt also provides an efficient means of profit extraction for investors. A wide variety of domestic exemptions from withholding tax on interest provide non-resident investors with minimal Irish tax leakage on investments in a Section 110 SPV. Interest paid by a Section 110 SPV to a person resident in an EU Member State (other than Ireland), or a country with which Ireland has a double tax treaty, (a relevant territory) is not subject to withholding tax on interest provided that it is not paid in connection with a trade or business carried on by the recipient in Ireland through a branch or agency. The exemption applies automatically without any application being required. In addition, interest on a "quoted eurobond" may be paid free from withholding tax to non-relevant territory residents where certain conditions are met.

Under Irish VAT legislation, management services (including portfolio management services) supplied to a Section 110 SPV can be supplied exempt from Irish VAT. This VAT exemption has been particularly favoured by specialists in distressed debt who can service distressed loan portfolios held by Section 110 SPVs without associated VAT costs. Coupled with Ireland's 12.5% corporation tax trading rate which should apply to the profits of a debt servicing company, Ireland has become an increasingly popular location for the acquisition and servicing of loan portfolios secured on Irish and non-Irish real estate.

IRELAND'S ATTRACTIVENESS

The rising interest in Irish property both from international and domestic investors is testament to the popularity of Irish investment structures. Between REITs, QIAIFs and Section 110 SPVs, there are a range of investment vehicles which should meet the requirements of most investors. Indeed, the combined use of QIAIFs and Section 110 SPVs can provide the benefits of both tax efficiency and extensive treaty access. Irish property and Irish investment structures are proving to be very attractive for international and real estate investments.

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