This technical query paper was submitted to Revenue in response to Revenue's comments/queries on the Institute's feedback, submitted on 8 July 2022, on the draft Tax and Duty Manual on the Interest Limitation Rule which was circulated to the TALC BEPS Implementation Subcommittee.

19 July 2022

We have outlined below Revenue's comments/queries (emailed on 13 July 2022) on the Institute's feedback submitted on 8 July 2022, together with the Institute's further comments in response

- Thank you for confirming our understanding that that the EIR and Fair Value methodologies would ultimately result in the same amounts flowing through the Income Statement.

- Thank you for confirming that it is possible, when using EIR accounting, to calculate what amount of income booked in the Income Statement is attributable to an improvement over original projected performance on acquired portfolios.

- We note the comment that there is no benefit [*to the Exchequer*] where the taxpayer does no better than meet its projected targets. I understand that this comment refers to the fact that, in example 4.5, the amount recognised in the accounts of F Ltd as finance income should be considered to be taxable interest equivalent and therefore would reduce any exceeding borrowing costs arising for that company. It should be noted that the proposal put forward in the feedback received (to treat all finance income recognised in the Income Statement as equivalent to interest regardless of how it arises) would result in amounts which are clearly not equivalent to interest being treated as such, and therefore potentially sheltering deductible interest equivalent from restriction which would be in contravention of ATAD.

  ITI Response: We would respectfully disagree with the comment that the amounts concerned are "clearly not equivalent to interest". We have set out, at length, in some of our previous correspondence how, in our view, they can be considered economically equivalent to interest within the ILR legislation.

- Regarding the comments on provisioning and the EIR method, it is noted that should a provision become realised the realisation of that provision is done through the

Balance Sheet and not through the Income Statement. You might please confirm the appropriate accounting on the creation of the provision? It is our understanding that the creation of a provision may arise from the revising down of performance expectations, in which case a loss would be recognised in the Income Statement? Were that the case, the debit to the P&L would need to be assessed as to whether it should be considered to be equivalent to interest.

ITI Response: In relation to the provisions issue, where the relevant taxpayer is using EIR accounting, to the extent it is obliged to book a provision this will involve a debit to the income statement and a credit to the balance sheet. It will, therefore, book its interest/interest equivalent income to the income statement gross of any provision amounts.

To the extent that that provision is crystalised, the accounting treatment is to offset the balance sheet liability against the loan receivable asset. This is done through the balance sheet such that there is no reversal of the provision through the income statement and equivalent write down/write back of the interest income booked to the income statement. This means that the income statement records a higher amount of interest/interest equivalent than is actually realised because the provision is not reversed in a manner that reduces the amounts of interest/interest equivalent credited to the income statement.

This can be contrasted to the effective accounting treatment applied to fair value accounting. Under these accounting rules, no provision for bad debt is separately booked. Instead, the amount is effectively netted against the amounts credited to the income statement in respect of the loan portfolio. Thus the amounts which are booked to the income statement are lower under this method of accounting than compared to the EIR method. We believe this creates an inequality between treatment for these companies.

- There are a number of comments regarding aggregation of loans or portfolios. The key principle being applied is that when a portfolio of loans are acquired it is to be treated as a single refinancing. What is then assessed is whether that financing performs above expectations with regard to loan performance such that a return above the expectations on acquisition (on the portfolio as a whole) is akin to an increase in principle and cannot be considered to be equivalent to interest.

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ITI Response: We would be grateful if you could clarify your above-mentioned comments. On a plain reading they might suggest that if a taxpayer acquires portfolio loans, they are obliged, for ILR purposes, to treat the entire portfolio as a single asset irrespective of the accounting treatment they adopt. As mentioned in our previous correspondence, the accounting rules will, depending on the facts and circumstances, allow or in some cases mandate that loans in a portfolio are treated separately for accounting purposes or in aggregate. To a certain extent, therefore, a taxpayer may have flexibility as to how they treat these loans from an accounting point of view. The above text might suggest that even if management were accounting for the loan separately that they should treat them as an aggregate single asset for the purposes of doing their ILR calculation – is this correct? If so, we would recommend that this is stated clearly in the TDM as we do not think that this is clear under the current drafting.

We note that this treatment means that when looking at loans within a portfolio, losses on some are offset on a 100% basis against gains on another. This is irrespective of the fact that we understand that a loss against the original basis in the loan is to be treated as an interest equivalent whereas the gain against which it is netted might not be an interest equivalent. Moreover, where the loss represents the reversal of a previous gain and, therefore, we understand to be treated as an interest equivalent it might well be set against a gain which is not an interest equivalent. This appears to lead to a very mixed picture and not consistent with the general principles that are being espoused in the TDM.

While we absolutely agree that it makes sense to simplify the approach adopted when trying to deal with large portfolios of complex financial instruments, we nevertheless feel there should be a consistent basis and that this basis can be achieved by treating the entirety of the return on the relevant portfolio as an interest equivalent. In any event, we certainly feel that clarity is needed as to whether or not this treatment is optional or mandatory and whether or not Revenue believe that the accounting treatment is relevant in that determination.

- There are a number of comments regarding legal interest versus interest equivalent. The example deals with a trading financing company with taxable income computed in accordance with generally accepted accounting practice subject to any adjustment required or authorised by law. Therefore, the taxable income of the company is based on the amounts recognised in its accounts. The legal interest receivable on the

underlying loans is not then taxable interest equivalent. Therefore, we do not agree that the taxpayer can choose to treat as taxable interest equivalents both legal interest plus the interest equivalent calculated per the example.

ITI Response: To avoid any misunderstanding in relation to the Institute's comments on the importance of making a distinction between interest under existing tax legislation (Legal Interest) and other forms of interest equivalents (Deemed Interest) our point here is that if a NPL is acquired with an interest accrual, legally any amounts that are paid on it will typically first be entirely allocated to discharging the accrued interest, until such time as all of the interest accrual is "caught up" and thereafter amounts will be applied in reducing principal.

This would be the case where there is an improved portfolio performance due to better debt collection results. In those circumstances where there is an improvement if there is still accrued interest on the relevant debt, the entirely of the amounts received will be Legal Interest.

This can be contrasted with the accounting treatment. As noted in previous correspondence, the entirety of the amounts received in an improved performance scenario are coded as interest in the financial statements. These amounts represent an accounting measure of "interest" i.e., the return on the amount paid to acquire the portfolio. Legally this may comprise amounts of accrued unpaid Legal Interest and amounts of discounted principal.

For these purposes, the accounting treatment essentially ignores whether the discount applied was in respect of the accrued interest or the principal or both. Instead, it simply records everything as "accounting interest" thereby eliminating the need for any distinction in this regard. Put another way because the accounting treats everything in excess of the amount paid for the portfolio as interest, whether the discount applied on the acquisition related to accrued Legal Interest or to principal is irrelevant; as a corollary no distinction is made in respect of the amounts received actually i.e. any amounts in excess of what was paid are treated as "accounting interest" irrespective of whether they are Legal Interest or amounts of principal. (Over time they might equalise, but they would be quite different in individual years and if a debt settlement / restructuring is done, the difference might not equalise at all).

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The example in the TDM does not seem to deal with the differences between the tax and accounting treatments. Simply put, there may well be circumstances where amounts which are booked as "accounting interest" in the income statement which are all Legal Interest (e.g., where all the payments received in that period were legally offset against accrued interest), all Deemed Interest (e.g., where all the payments received in that period were legally offset against principal), or a mix of both.

Where all amounts in the accounts are treated as interest for ILR purposes, the distinction is unimportant. However, where amounts representing an improved portfolio performance do not qualify as Deemed Interest, then one needs to know if they are, in fact, Legal Interest or not. If they are Legal Interest then, irrespective of the accounting treatment, they must be treated as interest for ILR purposes. This distinction between Legal Interest and Deemed Interest is clear from the ILR legislation and is set out plainly in the TDM itself (which refers to relevant case law etc). There is no statutory basis in the legislation to recast Legal Interest as Deemed Interest just because the accounting treatment lumps them together. It follows that if, for example, the entire amount is Legal Interest, then for the purposes of applying ILR, there is a statutory obligation on the taxpayer to reflect this in its ILR calculations. To do otherwise would be contrary to the legislative obligations of the taxpayer.

It is common ground that having to make this distinction would clearly create an enormous administrative burden for the taxpayer (and the Revenue auditor). A company would, in essence, need to separately track for each loan in its portfolio what amounts relate to Legal Interest and what amounts relate to repayments of principal.

It is for this reason that we proposed (and, we understood, Revenue had accepted) that it was necessary to have a simplified approach, i.e., that ILR is legislated for such that all movements booked in an income statement under Section 76B as treated as interest equivalents for Case I taxpayers (being the taxpayers who would have large portfolios where individual loan tracking would be especially onerous). This approach would take everyone back to the above-mentioned situation whereby the legal and accounting treatments, while different in their components, are the same in aggregate.

If we do not get to this understanding, then there is a significant unanswered question for taxpayers as to how they reconcile the statutory position with what is shown the example.

- Can you please confirm that it is the view of the Institute Reps that it is impossible to assess fair value movements recognised in the Income Statement of a company with respect to a portfolio of loans, to determine what amount of the fair value movement is associated with improved performance on the loans, relative to expectations when the fair value of the loans was assessed on acquisition? The submission refers to a number of variables in determining the fair value of a portfolio. If all variables were held constant, apart from estimations of cashflows related to performance, would this separately identify the fair value movement that has arisen as a result of performance?

  ITI Response: While it is impossible to give a universal answer to all possible scenarios, it is important here to reiterate our previous comment that in the case of somebody applying Fair Value accounting, there will be no practical basis to determine the difference between expected and actual performance unless an entirely separate set of books and records is maintained for each and every loan asset.

  This is because the valuation (upon initial recognition and on re-evaluation) is made in respect of the total cash flows without any distinction being made between interest and principal – with that valuation usually being based on an external reference rate and an estimate of the credit risk for that particular borrower. When a revaluation is done, there is disaggregation of the elements of the calculation i.e., there is no comparison between the original and revised cash flow components into interest and principal.

  Even if this were done, it is certainly our view that it may be all but impossible (and at a minimum extremely difficult) to try and draw the distinction suggested between what elements of fair value movement of the segregated interest component relates to improvement of portfolio performance and which amounts relate to other factors. Indeed, the manner in which the fair value movements is determined does not seek to differentiate between, or make a separate of, these factors but rather looks at overall market performance. This would be with reference to external market prices (or some proxy thereof) and it is applied to total cash flows. Those

market prices do not draw a distinction between these factors, they simply reflect what the market thinks the current price of the relevant debt is.

Therefore, one would need to try to reverse engineer this into different components that might somehow be implicitly reflected in the market price. This would be extremely subjective and the judgment of two taxpayers with identical assets could easily come to different conclusions on each component, even while agreeing about the overall market price.

Apart from the fact that we would not expect anyone affected to have set up an accounting system to try and do this, we also do not know how this could be reasonably audited by Revenue should they wish to do so. The idea of trying to artificially hold other factors constant does not seem to be a practical approach in our view because if you are looking at external market forces, there is no easy way to do that.

ITI Additional Comments

The example in the TDM deals with 'non-performing loans'. From an accounting perspective there are, in broad terms, three loan categories:

- When originated a loan is automatically in Stage 1 and stays there unless it drops into stage 2
- Stage 2 arises where a loan is in arrears for more than 30 days – it is called a Significantly Impaired Credit Risk (SICR) – it is not uncommon for SICR loans to move back and further between Stage 1 and Stage 2 where the borrower is having some difficulty but is generally able to catch up on overdue payments
- Stage 3 applies to loans more than ninety days in arrears – known as Credit Impaired Loans

Where a loan portfolio is acquired, as the loans are 'new' to the buyer they are all in Stage 1 as they are priced on the basis of expected performance (which will vary depending on their performance history). However, loans in arrears fall into the Purchased or Originated Credit Impaired (POCI) category – a special subset / variant of stage 1. They remain in this category unless they deteriorate in which case they go to stage 2 and on to 3 potentially.

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When a loan (portfolio) is purchased at a discount, it might be fully performing but a discount is warranted as the terms do no reflect current market conditions (e.g. an historic tracker loan). Independent of this discount, there may be a discount because the loans are in stage 2 or stage 3.

As noted, the example only applies to 'non-performing loans'. We suggest that some comment or examples are needed to clarify if and how Revenue would differentiate based on the above classifications.

If Revenue intends to maintain its position on interest equivalence per example 4, we would suggest that loans in stage 1 and even stage 2 should be said to be excluded. Given their general 'good quality' any discount applied is most likely due to market performance and while an improvement in collection performance cannot be ruled out, it would seem likely that its effect would be very small on a loan-by-loan basis.

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Appendix

Further feedback in relation to the draft TDM on Interest Limitation Rule

8 July 2022

We thank Revenue for their detailed responses to the feedback we submitted on the draft Tax and Duty Manual (TDM) on the Interest Limitation Rule (version circulated on 1 June 2022), which we received on 1 July 2022.

We note Revenue requested further explanation and details on why it would not be practical to apply the same principles outlined in Example 4.5 in the draft TDM on page 24 to portfolios which are held at fair value. We have provided further details on these difficulties in the points below.

Portfolios held at Fair Value

- Revenue's presumption that the EIR and Fair Value methodologies would ultimately result in the same amounts flowing through the Income Statement is strictly correct but there are significant issues based on how the Interest Limitation Rule (ILR) works, particularly for Fair Value methodologies.

- It would, in principle, be possible when using EIR accounting to figure out what amount of additional uplift in interest booked in the Income Statement is attributable to an improvement over original projected performance. However, for some asset classes, particularly Purchased or Originated Credit Impaired (POCI) loans, it would be difficult to disaggregate this into the components of improved collection versus increases in reference rates, etc.

- With any projected returns, there would be a range of possible outcomes. It would appear that the methodology laid out by Revenue might encourage an aggressive approach in relation to determining expected return on a portfolio (i.e. within the range but at the highest end) rather than a more conservative one (which might otherwise be the preferred commercial approach).

- Unlike Fair Value accounting, the EIR methodology also makes use of provisioning. We understand that Revenue do not consider provisioning in relation to interest or interest equivalents to be treated as interest or interest equivalents. This creates a substantial difference between EIR and Fair Value accounting as there is no provisioning included in Fair Value accounting. This is not solely a timing difference due to the fact that where a provision has been created, should that provision become realised (because, for example, the amount provided will not be received) the realisation of that provision is done through the Balance Sheet and not through the Income Statement i.e., the provision is set-off against the gross asset receivable. Therefore, because provisions are not treated the same as interest/interest equivalent, there will be an important distinction for EIR and Fair Value calculations.

- The fact that the example in the TDM allows for the possibility of treating a portfolio of loans as an aggregate composite means that arbitrary results may emerge. This is particularly the case where losses against original purchase price/principal are not treated as an interest equivalent.

- Where loans are bucketed into a single portfolio of assets, any such losses will effectively be offset against any improvements which are treated as an interest equivalent. This means that there will be an entirely arbitrary treatment for tax purposes depending on the accounting practice and policy of the particular entity and management.

- Moreover, there could be different risk buckets within a loan book of a SPV in relation to different risk portfolios. This means that you could have situations where there is offsetting between one portfolio of a certain risk but not between portfolios where there is an overall loss in one and gain in the other. This also appears arbitrary.

- It should be noted that new entities will be better able to structure their analyses of portfolios into buckets to avail of this anomaly; whereas existing entities will be locked into their existing accounting practices. This means that there is an inequitable treatment between older and newer entities.

- The NPL example does not address the fact that, in the case of non-performing loans, there will a substantial amount of purchased interest in respect of those loans.

Elsewhere in the draft TDM, there is a clear explanation that real/legal interest is to be treated as interest, yet this example does not recognise this and considers only interest equivalents.

- The proposed simplification of following the accounts was to avoid the necessity of otherwise having to separately track the interest on all loans.

- If a taxpayer follows this example, will they be in compliance with the law in terms of tracking their interest and interest equivalents as mandated in the legislation? Is Revenue of the view that a taxpayer could be relieved of their legal obligations simply by virtue of this example?

- On the face of it, the taxpayer could treat as Taxable Interest Equivalents:
  (a) the real / legal interest; plus
  (b) the interest equivalent calculated per this example.

- As noted, the proposed disaggregation of amounts relating to improvement in performance could be determined under EIR albeit further disaggregation into the factors driving that improvement would be very difficult for some asset classes (particularly POCI loans). However, in the case of somebody applying Fair Value accounting, there will be no basis to determine the difference between expected and actual performance unless an entirely separate set of books and records is maintained for each and every loan asset.

- This is because when people apply Fair Value accounting, the day one accounting is normally, in an arm's length transaction, the transaction price because this is indicative of the Fair Value of the transaction. However, subsequently to day one, they will first look at their projected cash flows and the period of time over which they are expected to be received (for example assume six years).

- They would then seek to apply an appropriate interest rate to discount those cash flows back to their present value such that they can determine the amount that should be recorded as the asset on their Balance Sheet.

- This would typically involve looking at an external reference rate such as the six year Euribor rate for these purposes (say that is 1.5%) and then they would look to establish the credit risk for that particular borrower (e.g., they might look at

Bloomberg and determine that the relevant entity has a risk rate of 4.5%). They then apply this 6% discount rate to the projected cash flows and record that as the Fair Value of the asset.

- Each year they will then undertake a re-evaluation of the loan asset using exactly the same approach as above i.e., look at the revised reference rate and the revised overall risk rating for that particular borrower and apply that rate to the expected cash flows. If there were no changes, an amount would be booked to the Income Statement reflecting the overall profit based on the original projections i.e., the difference between the cash received in that period and the discounted amount recorded in the Balance Sheet.

- However, to the extent that there are changes (e.g., say the rate dropped from 6% to 4.25%) then you will have an amount booked to the Income Statement. Critically, there will be no distinction made between the amount that would have been booked and the amount that actually is booked because no accounting system would be set up to separately measure these two amounts.

- These amounts might be different for different loans in the portfolio and will change over time. This means that increases in one period might be then offset by reductions in another.

- No-one using Fair Calue accounting would set up in the normal course of business a separate tracking system to try and determine what the amounts would have been had performance continued as originally projected versus how they would have changed because the purpose of Fair Value accounting is simply to book the present value on the Balance Sheet, not to determine what would have been booked in the Income Statement over time. The amount that is actually booked to the Income Statement in a given year is the aggregate of the total results for the period and the change in projected values.

- Moreover, the discount rate applied is almost certainly not going to be an exact measure of the performance of the particular loan asset (merely an assessment sufficiently good for accounting purposes). To the extent that a discount rate is determined based on externally derived data, while that rate will be modified to attempt to take account of factors specific to the borrower, the resultant rate will

still be an estimate made in respect of a third-party (the borrower) about whom the lender has limited information.

- Further compounding the issue, many borrowers may not have a Bloomberg or equivalent public rating and instead, one would seek to use market data to work out an estimated rating for the borrowers concerned and would then make further adjustments specific to that borrower (which, as noted above, will be estimates based on the limited knowledge the lender has about the borrower).

- Given the many inputs that will be involved in estimating the Fair Value of a particular loan, it will be impossible to breakdown the movement between what is driven by movements in external reference rates or other market movements and between increased collections.

- As a result, we think that trying to apply these principles to a company which uses Fair Value accounting will, in practice, be impossible and the resulting TDM will have no practical impact for them. Instead, they will be left with the situation which was originally intended to be avoided whereby they will have no real choice but to try to come up with their own measure of interest (being the actual interest that they receive) and/or some other measure of interest equivalent which will have no real comparison to the example in the TDM because that example will not be capable of informing that estimation.

- The complexity that this example introduces should be measured against the benefit to the Exchequer. There is no benefit where the taxpayer does no better than meets its projected targets. As noted, with any portfolio of loans there will be a range of projected outcomes and taxpayers might now be incentivised to pick a position at the far end of that range. Where they do so, the probability of them exceeding that original assessment falls and so does the likelihood of any net benefit to the Exchequer.