WHY LETTING SECTION 110 SPVS OPERATE IN THE IRISH DOMESTIC ECONOMY WILL DAMAGE OUR TAX BASE AND OUR REPUTATION AS A 'LOW-TAX' ECONOMY

OBSERVATIONS & RECOMMENDATIONS by Stephen Donnelly, T.D.

September 2016

Note: All tax avoidance described herein, attributable to named and unnamed firms, is believed to be legal. There is no suggestion that any Section 110 SPV, or their parent company or companies, or related firms and/or individuals, are engaged in tax evasion or are in any other way non-compliant with Irish law.

1 What's happening: High tax avoidance on Irish domestic gains

1.1 A small number of foreign investment firms (so-called 'vulture funds', referred to hereafter as vulture funds) have purchased considerable Irish domestic assets in recent years. They have deployed almost €20bn in invested equity[1]. These assets have been sold by entities including NAMA, IBRC and other Irish banks, and include property and loan books consisting of mortgages, personal unsecured and commercial loans.

1.2 Many of these funds have structured their Irish investments through SPVs with Section 110 status[2]. Section 110 was created to facilitate global securitisation deals being administered from Ireland. As these global securitization deals have nothing to do with the Irish economy, the State – rightly – allows these Section 110 SPVs to be free of all Irish taxes, Irish VAT and Irish duties (the so-called 'tax-neutral' position).

1.3 We know from the vultures own brochures that a 15% IRR over 10 years is their benchmark investment return (i.e. a €100m equity investment becomes €400m after a decade)[3]. Our own individual Case Studies[4] show that in just 2 years post investment, many vultures are well on course to achieve this. However their use of Section 110 SPVs means that practically none of their gains in Ireland will be subject to any Irish taxation.

1.4 Analysis of published CRO accounts for the vulture fund Section 110 SPVs suggests that the total quantum of Irish taxes avoided will approximately equate to the total equity invested by these vulture funds in their Irish deals. **Given that these vulture funds have invested almost €20bn in equity in Ireland (or over €40bn including their debt), that comes to almost €20bn in potential Irish taxes avoided.[5]**

1.5 Our Case Studies, and expert input, tell us that most NAMA / IBRC / Other loan books were sold at yields of c. 8-10% per annum (vulture funds can then use cheap bank debt

[1] By the end of 2016, c. €80bn in Irish loan balances will have been sold for c. €40-45bn in cash. Vulture funds typically use 50-60% senior debt to finance their purchases, thus requiring c. €18-22bn in vulture fund equity.
[2] Taxes Consolidation Act, 1997
[3] Oaktree Investor Presentation Q2 2016; Cerberus Investor Presentation Q1 2016
[4] See Case Studies provided for Cerberus' Project Eagle and OakTree's Mars Capital Ireland
[5] About 50% of the total cheque paid to NAMA and other vendors is the vulture fund's own equity, while the other c. 50% is 3rd party bank debt financing.

to leverage these yields to c. 15-20%). Assuming €40-45bn in total sales, this 8-10% per annum equates to c. €4bn on annual Irish income in going untaxed. **Taxing this income would add approximately €1bn per year to the fiscal space.**

1.6 On top of this, significant capital gains are being realised on the purchased assets. Examples are provided in the Case Studies below. Taxation of this gains would be less smooth than for interest payments, but **taxing the capital gains would add, on average, about another €1bn per year to the fiscal space.**

1.7 In response to this issue being raised, Minister Noonan published a draft amendment to Section 110, to be included in the Finance Act. The stated intention of the amendment is to stop Irish tax avoidance by vulture funds. The Minister has also asked for engagement across the House on potential issues with the draft amendment.

1.8 The amendment, as currently drafted, will fail to curtail Irish tax avoidance by vulture funds, and further, will legitimise broader tax avoidance by foreign and domestic firms in Ireland. Within 24 hours of the draft amendment being published, accountancy firms had issued advice to their clients on how the amendment could be dealt with.

1.9 Several proposals are provided below, with the following core aims:

1.9.1 Curtailing unwanted tax avoidance techniques in the domestic Irish economy;

1.9.2 Protecting Ireland's reputation as a 'low-tax' economy and not a 'tax-haven';

1.9.3 Creating the transparency and oversight needed to control all zero-tax vehicles.

1.10 While this memo focuses on the use of Section 110 SPVs by vulture funds in the Irish domestic economy, it should be noted that a range of new tax avoidance mechanisms are being used to avoid taxes on other gains generated in the Irish domestic economy (i.e. QIFs and ICAVs etc.). It is unclear what the scale of total avoided Irish taxes might be for these, but it is believed to be material, and must be similarly addressed.

2 Why this matters: i. Ireland's 'low-tax' reputation

2.1 Minister Noonan has rightly acknowledged that changes are needed to Section 110. He has stated that gains realised in the Irish domestic economy should be taxed in Ireland (Section 110s pay no Irish corporation tax, withholding tax, VAT or stamp duties).

2.2 Unfortunately, the proposed Section 110 amendment will allow a small group of firms to continue to offshore their domestically generated income and capital gains, via their SPVs, such that at least €10bn[6], if not €20bn of Irish taxes could be avoided. The main issues with the amendment are 'mark-to-market' relief and the continued 'deductibility' of non-3rd party bank interest against all Irish profits (see further details below).

2.3 Worse is that the proposed amendment confirms that Section 110 SPVs can operate in the Irish domestic economy. It does this by stating that the curtailments on tax

[6] Only if ALL vulture funds availed of full Irish Withholding Tax relief (which means they can't offshore their loans in the Caymans etc.) AND managed to get the lower Irish CGT rate of 20%, on ALL Irish capital gains.

avoidance will apply only to 'property businesses'. Allowing zero-tax vehicles operate in your domestic economy is one of OECD's 3 core components of a 'tax-haven'.[7]

2.4 Ireland's SPV industry is now expanding the use of Section 110 SPVs into Qualified Investment Funds, QIFs, including so-called 'Super QIFs', and 'Orphaned Super QIFs'. These structures are not required to file accounts with the Companies Registration Office, CRO. They are also bespoke funds, and their tax structures, and what Revenue allows each fund to do, are not publicly accessible. As such, these funds would appear to meet the other 2 OECD criteria for tax havens – Protection of company financial information and lack of transparency and full ongoing regulatory oversight.

2.5 Ireland has a transparent taxation system and a competitive low-tax economy that other developed countries find difficult to copy. The European Commission's Apple ruling re-affirmed support for this low-tax status in the EU. However, this advantage only exists because Ireland has full un-restricted tax treaties with all major countries. Without such treaties, Ireland would not attract Foreign Direct Investment, FDI, as it has. There is a reason why Google, Apple and Microsoft are not in the Isle of Man.

2.6 To be clear, Ireland is not a tax haven. However, these new tax avoidance mechanisms do not help with that position. Ireland has now been branded a 'tax haven' by Brazil. It is imperative that a clear signal is sent out that nothing could be further from the truth. It is critical that Ireland's reputation as a transparent, fair, 'low-tax' economy is upheld. 38,000 IFS jobs, which exist because of our full un-restricted tax treaties with all major OECD countries, rely on this reputation. Several recent actions have been undertaken to this end, in line with the OECD's BEPS process. Shutting down zero tax, VAT and duty structures in the Irish domestic economy, is another key step.

3 Why this Matters: ii. A level playing field for all

3.1 Irish citizens, SMEs and Corporates are growing increasingly uneasy about an economy that appears to provide almost complete immunity from Irish taxation to certain foreign investment firms on any gains these firms have made on investments in Ireland.

3.2 Irish Families trapped in the housing crisis need to know that the State does not shield funds buying tracts of Dublin housing, in tax-free and stamp duty-free SPVs[8].

3.3 Irish Families who have had their mortgages and loans bought by vulture funds (at deep discounts) need to know that these funds are paying full Irish taxes on the profits generated by the interest and capital payments of these same, tax-paying, families[9].

3.4 Irish SMEs, who pay their Irish VAT and taxes, must be confident that the funds who bought their loans at a discount do not live in a parallel tax-free, VAT-free universe.[10]

3.5 Irish Corporates need to know they're competing domestically on a level playing field. How can Bank of Ireland, Ulster Bank and KBC be asked to pay Irish corporation & withholding taxes, while competing lenders use Section 110 SPVs to pay zero taxes?[11]

---

7 "Tax-Haven Criteria", OECD, February 2008
8 "Foreign investor firms responsible for around a fifth of Dublin house purchases" theJournal.ie 23-09-2016
9 "How did the Government shaft Mortgage Holders and Taxpayers in one fell swoop" Independent 10-07-2016
10 "Revenue warns SMEs over sale of their loans to vulture funds" Irish Times 26-03-2016

4 Why this matters: iii. €20bn in lost taxes vs. €50m pa in fees

4.1 It is important not to confuse the contribution of Section 110 SPVs with the 38,000 jobs derived from the wider IFS Industry. The global multi-national companies Ireland has built its 'low-tax' economy on do not rely on Section 110 SPVs. Outside of Irish advisors, few people work in Section 110 SPVs. They are 'virtual' legal structures.

4.2 The Central Bank of Ireland, CBI, estimates there are c. 600 SPVs[12] using Section 110 in Ireland. [13] It notes that it costs c. €60,000 on average to administer these annually. This suggests an annual gross fee income of c. €36m per annum to the economy.

4.3 The CBI also notes that it costs c. €50,000 to set up a Section 110 SPV, but industry sources suggest set-up fees are closer to c. €200,000. With c. 60 new SPVs set up annually, that's another c. €12m p.a. in gross fees (using €200,000 assumption).

4.4 This suggests that the entire SPV Section 110 industry in Ireland generates approximately €48m annually in gross fees to Ireland's accounting and legal firms. This includes all vulture fund SPVs, plus all normal global securitization SPV business.

4.5 The Cerberus (Project Eagle) and Oaktree (Mars Capital) Case Studies show that the total Irish domestic taxes avoided by the vulture funds via Section 110 SPVs, could exceed the €20bn in equity investment which these funds have made in Ireland.

4.6 A targeted amendment will address the €10-20bn of Irish taxes avoided without affecting SPVs using Section 110 for global securitization (the purpose for which Section 110 was created). However, in the context of under €50 per annum in monetary contribution, versus €10-20bn in Irish taxes avoided, decisive action must be taken.

5 Amendment Loopholes: i. 'Marking-to-Market'

5.1 Accounting firms came out quickly after the draft amendment was published, clarifying to clients using Section 110 that they could shelter all capital gains under 'mark-to-market' relief (this was despite the fact the amendment was silent on 'mark-to-market').

5.2 **Take the following anecdotal example:** A vulture fund buys a typical asset off NAMA in 2012 at an income yield of c. 10% by paying 25 cents in the Euro. It did this when Irish bond yields were over 8%. Irish bond yields are now closer to 0%, Irish loan recovery rates have increased significantly, as have Irish commercial property and Irish land values. These factors will double, or triple, the value of the asset, versus the 2012 purchase price. CGT should be liable on these gains. However, if the vulture fund were allowed 'mark-to-market', or reset the value of its portfolio, free of CGT, to 5th September 2016, they will have been allowed avoid very significant CGT.

5.3 One accounting firm notes this 'mark-to-market' relief makes Section 110 SPVs inherently valuable (i.e., clients should sell their SPV with any unused CGT relief

---

[11] "Lender Cardinal Capital warns of damage to lending by S110 reforms" Irish Independent 11-09-2016
[12] The domestic tax avoidance is via SPVs, it does not involve the other Section 110 vehicles such as FCVs
[13] "Profiling Special Purpose Vehicles Activities in Ireland" Central Bank of Ireland, Qtly Bulletin (Q2 2015)

inside, rather than selling the SPV's assets). This would allow future tax avoidance be sold with the assets, and means Irish assets are kept out of the Irish tax base for longer.

5.4 Case Studies of Section 110 SPVs relating to Cerberus and Oaktree show how 'mark-to-market' could be used to shelter all capital gains (£1bn in the case of Cerberus on Project Eagle). The Case Studies show that typically the split of income to capital gains is roughly 50:50. So half of the €10-20bn in potentially avoided Irish taxes will be sheltered if this 'mark-to-market' mechanism is allowed to shield future capital gains.

5.5 It is hard to find a major country where increases in CGT (for corporates or citizens), come with 'mark-to-market' relief for unrealised gains. Applying CGT on undeclared or unrealised capital gains is not retrospective taxation. There is no precedent for it.

5.6 Furthermore, in replies to parliamentary questions, Minister Noonan has stated that no assurances of any kind were provided to any Section 110 firms regarding their ability to offshore profits.[14] As such, it is unclear why 'mark-to-market' would be necessary.

6 Amendment Loopholes: ii. 'Deductibility' of Non-Bank Interest

6.1 Accounting firms have provided their interpretation of what allowing non-bank interest deductibility at an 'arms length'[15] rate means, along with steps their clients can take to continue to shelter all future income gains under Section 110, even for property SPVs.

6.2 **Take the following anecdotal example:** Take an Irish business owner's accounts showing an EBIT[16] of €1.5m and interest payment to AIB of €0.5m. The company would, normally, then be taxed on the €1m of Pre-Tax profits. However, imagine the business then claimed to Revenue that it made no taxable profit, as it had paid the €1m in interest to an 'internal' loan, based in the Cayman Islands, which the company owner also owned. Add further that the internal loan was explicitly accounted for in the company accounts as having a variable interest rate that could be changed to match all Pre-Tax profits the company made. It is unlikely that this setup would not be accepted by Revenue. However, it is illustrative of what is happening under Section 110 SPVs in Ireland, and what would still be possible without updating the draft amendment.

6.3 Experts advise that clauses like this – deductibility of non-bank interest – as allowed in the draft amendment, can be used to structure 'internal' or 'semi-internal' loans, based offshore, to re-route all future Irish income and gains via the 'variable interest' charged.

6.4 Interest deductibility was created to allow businesses offset genuine third party bank interest costs against taxable profits. It was not created to allow 'financial structuring' re-route Irish profits offshore via 'internal' loans (at 'arm's length' interest rates).

6.5 Simply stopping the 'variable interest' nature on these non-bank internal loans would also be ineffective. It is reasonable to assume that vulture funds could commission

---

[14] DÁIL QUESTIONS addressed to the Minister for Finance by Deputy Stephen S. Donnelly for WRITTEN ANSWER on 21/07/2016: "I or my Department did not give assurances in any form to the bidders and purchasers of any distressed debt loan books sold by NAMA, IBRC, or any other entity in relation to the offshoring of profits by such companies or the establishment of section 110 companies to purchase and or manage the loans. Furthermore I am not aware of any other state agency or official giving such assurances."

[15] Draft Amendment 5A(c)(ii)

[16] Earnings Before Interest & Tax

reports from accounting firms stating that very high levels of interest on these 'arms-length' loans are reasonable, and that this high levels would approximately match total domestic gains, again leading to little taxable profit being declared in Ireland.

7 Amendment Loopholes: iii. Section 110 for non-Property

7.1 The draft amendment only concerns Section 110 being used for Irish property. By implication, the amendment could legitimise Section 110 for all other classes of qualifying Irish assets in the Irish domestic economy. This could turn Ireland into a full blown 'Tax Haven', where with the right advice, you can avoid all Irish domestic taxes.

7.2 **Anecdotal expert input provided the following example:** Instead of an investor or entrepreneur buying an Irish business, they could arrange for the business to restructure its equity into debt. Expert advice suggests that the process of replacing businesses' equity, into internal debt, takes about a week. A Section 110 SPV could then buy this debt, fully control and operate the business, but use the Section 110 SPV to siphon all the business profits (income and capital), gross and untaxed, offshore.

7.3 Expert input gave examples of how allowing Section 110 SPVs to operate in the domestic Irish economy can be used to by-pass many other Revenue rules. New hybrid Section 110 SPVs such as "Super QIFs" and "Orphaned Super QIFs" are examples[17].

7.4 We saw the level of tax abuse that was going on with Irish personal pension Small Self Administered Plans ("SSAPs"). It was so bad that Revenue had to limit SSAP assets to €2m. And the pension area is well regulated and overseen by several State bodies.

7.5 Ultimately, if the State allows vehicles free of Irish tax, VAT and Duty, like Section 110 SPVs to operate in the domestic economy, the State will be plugging 'loopholes' for life. And as tends to be the trend, the State will find these loopholes years too late.

8 Recommendations: Protect our "Low-Tax" Reputation.

8.1 **Explicitly rule out 'mark-to-market' relief in the amendment.** Ireland cannot show the world, our EU tax-treaty partners, and our own business community and citizens, that tax avoidance on domestic Irish gains will be rewarded and protected by the State. A small number of firms are using Section 110 SPVs to avoid Irish taxes (on a very large scale). There can be no acceptance of 'locking in' this tax avoidance on all gains.

8.2 **Remove any deductibility for non-bank interest for Irish domestic vehicles.** Allowing interest deductibility on all classes of loans (internal or otherwise) is important for the SPVs that operate in the global securitization industry. It is not acceptable for Irish domestic companies, or any another class of tax vehicle operating in the domestic economy, to be offsetting non genuine third party bank loan interest against Irish taxable income. Allowing deductibility of non-bank loan interest is one of the most valuable tools that a 'financial engineer' has in avoiding Irish domestic taxes.

---

[17] I attach a guide from Davy Stockbrokers on turning Qualifying Investment Funds ("QIFs") into a Section 110 tax vehicles, which are called a Super QIF (private clients) or Orphaned Super QIFs (institutional clients)

8.3 Remove Section 110 status for all economic activity in the domestic economy. The State has a valuable asset in Section 110 SPVs administering global securitization deals from Ireland (the purpose for which they were originally created). However, the State cannot tolerate SPVs that are free of Irish corporation tax, withholding tax, VAT and Stamp Duties on gains made in the Irish domestic economy. The State will never get ahead of the private sector advisors in terms of plugging the loopholes, and so the source of the loopholes should be removed. This will protect both Ireland's tax base and international reputation as a transparent and fair 'low-tax' economy.

8.4 Require all SPVs (and Irish zero-tax vehicles) to get prior Revenue Approval. Zero-tax Section 110 SPVs do not need approval from the State to operate – they only need to notify Revenue[18]. It seems that the Irish Central Bank and the Irish Revenue were not initially aware of what Section 110 SPVs were doing in the domestic Irish economy. To prevent this happening in the future, all future – and existing – Section 110 SPVs must get prior approval from Revenue (and potentially the Central Bank).

8.5 Mandate all Irish tax-free type vehicles, to publish their accounts on CRO. The use of Section 110 SPVs by vulture funds came to light because Irish media and politicians could access their filed accounts from the CRO. Secrecy and lack of transparency are hall-marks of a tax-haven. One simply cannot avail of tax breaks in Ireland and be entitled to secrecy. QIFs, ICAVs, FCVs, and any other acronym, must publish their accounts with the CRO (like all other legitimate Irish tax compliant firms).

8.6 Create on-going Oireachtas oversight of tax avoidance. The complexity of tax avoidance structures in Ireland, the materiality of the monies involved, the substantive international commercial and political risks associated, the numerous relevant State actors, and other factors have led to a situation where the State is well behind the curve in terms of ensuring that only intended tax avoidance (e.g., like in global securitisation) is happening. Regular expert input and review is required for the Oireachtas. This could be housed in one of several locations, including The Budget Oversight Committee, The Finance Committee or possibly a new Tax Oversight Committee.

9 Consequences: Reputation aside, it makes financial sense

9.1 SPV business – We may see legitimate Section 110 SPVs leave under fears we have changed tax policy. The amendment can be targeted so that it does not affect any Section 110 SPV with non-Irish assets. Strengthening Ireland's reputation as a transparent and fair 'low-tax' economy should increase Section 110 SPV activity on international assets. However, even if some securitisation SPVs were to decide to leave, their contribution to the Irish economy should be compared with €10-20bn in Irish taxes saved. Furthermore, market nervousness will be best addressed by producing an unambiguous position on Section 110 SPVs status, and that they are fully supported for global securitization deals, but prohibited for use in the domestic Irish economy.

9.2 NAMA bids – We may see lower bids for NAMA's remaining assets from foreign firms. This is a reasonable position. However, as the two Case Studies provided show, the quantum of Irish taxes being avoided can equate to over half the headline NAMA sales price (i.e. including debt and equity). For example, Project Eagle alone could see over £600m in potential Irish taxes be avoided versus a £1.2bn sale price. As such, the

[18] "IRELAND: The SPV Jurisdiction of Choice for Structured Finance Transactions", Matheson Law Firm

benefits of shutting down this Irish tax avoidance mechanism for all domestic investment activity far outweigh any potential fall in prices bid to NAMA.

9.3 **Foreign Capital Lending – We may see less foreign capital available to lend in Ireland.** We cannot, under Irish or EU competition law, allow a system where a Section 110 lender avoids all Irish taxes, Irish VAT and Irish duties, while Bank of Ireland, AIB, Ulster Bank, KBC etc. pay full Irish taxes, VAT and duties. Such a position is not sustainable, and grossly unfair to domestic investors and businesses.

9.4 **Litigation – We may see law suits from vulture funds using Section 110 SPVs.** This may happen, as €10-20bn is a large number, even for the international investment firms involved. However, Minister Noonan has stated that no comfort was ever given by any organ of the State to any vulture fund, or any of their advisors, as to whether it was legitimate to use Section 110 status to offshore domestic Irish gains. It is highly unlikely that such treatment would ever be afforded to standard Irish businesses (and none that we know of use Section 110 SPVs in the domestic economy) and so it is unclear why such treatment would ever have been assumed to be given by the firms involved. In any case, the scale of potential benefit to the Irish Exchequer is such that there should be no fear of defending against any potential law suits.

9.5 **Property values – We may see less international interest in Irish property, lowering demand and prices.** It is entirely possible that ensuring international investors in Irish assets pay the same levels of Irish taxation as domestic investors will lower international demand for Irish property. In the middle of a housing crisis, this should be seen as a positive effect. Irish buyers are currently competing with international capital which can 'offshore' its Irish profits to avoid paying Irish tax. This is an entirely unacceptable situation. It can be seen anecdotally in the fact that 50% of new house and apartment purchases are for cash – squeezing out the squeezed middle.

10 APPENDIX

CASE STUDY #1: Cerberus £1.2bn acquisition of NAMA's Project Eagle in 2013

1. Deal Structure (£GBP).

Loan Par Value		£4.6bn
Price Paid		£1.2bn (27p in the £1)
Funded by	:	£760m Bank Debt (from NOMURA Japan, BAWAG Austria)[19]
		(Note: The bank debt is non-recourse and at a <65% LTV)
	:	£440m Equity (from Cerberus)
		(Note: The equity is structured as a Section 110 PPN Loan[20])

2. Year 1 Income (from Cerberus Promontoria Eagle Section 110 SPV Accounts).

2014 Gross Income	£112m (not including any repayment of principal[21])
2014 Bank Interest	£27m (3.5% + LIBOR on the Bank Debt)
2014 Pre-Tax Income	£85m (Gross Income less Bank Interest)
2014 Cerberus Interest	£85m (Section 110 PPN Loan interest of '10% + Variable'[22])
2014 Taxable Profit	£0m (tax of £1,947 paid in 2014, which is lost in rounding)

3. Key Distressed Debt Metrics – High Income Yield + Possibility of High Capital Gain.

Start Unleveraged Yield 9.3% (£112m divided by £1.2bn)

Note: this is a typical NAMA / IBRC loan portfolio sales yield – 8-10% unleveraged income.

Start Leveraged Yield 19% (£85m pre-tax income divided by £440m Cerberus equity)

Note: most vultures used a 50-60% LTV loan @ 3-4% interest to double unleveraged yield

Discount to Par Value 27p in the £1 (£1.2bn paid for £4.6bn of loans)

Note: the big discounts to loan par value, mean that Project Eagle loans cannot be paid back early (i.e. Cerberus cannot lose the 19% income yield) without getting a large compensating capital gain. So great was the discount to par value in Project Eagle, that Cerberus will be willing to cancel loans paid back at 50p in the £1, and still get a return of well over 19% p.a.

[19] Some of this bank loan was paid down immediately post the deal to give a current balance of £730m.
[20] A Profit Participating Note is an 'internal' loan where the interest charge is set up 'sweep up' any pre-tax profit
[21] This was £100m in 2013, but NAMA (per C&AG report) expected it would be £85m in 2014.
[22] Note Cerberus paid 'internal' fees and expenses in 2014; however in effect, it is all the same.

4. Hypothesised Cerberus Strategy – Let time do the work over next 10 years.

The C&AG report shows NAMA incorrectly assumed buyers of Project Eagle would sell down the portfolio over 3 years to re-coup their capital. This was a misunderstanding of what Distressed Debt funds do, which is to hold for +10 years for the income yields, and let time work for them to make additional capital gains by improving the loan recovery rate.

Even though NAMA's cost of capital was lower than that of Cerberus (NAMA should have been a perfect Distressed Debt investor), NAMA rushed to sell a 9% yielding asset.

The hypothesis is that Cerberus' actual strategy will be the classic Distressed Debt work-out:

1. Lock down the portfolio for the next 10 years and let time fix the asset values;
2. Ensure that the 19% per annum income comes in over the next 10 years;
3. Check that any borrower who can pay more, does so (i.e. improve 19% per annum yield);
4. Take action on any non-income paying borrowers and recover asset;
5. As the discount was so big (27p in £1), do deals where borrower can repay 2x (54p in £1).

5. Potential Cerberus Returns – £1,950m (44% income and 56% capital).

1. 19% per annum on €440m for 10 years = €850m in income.
2. Improve recovery to 50 cents in the €1 (standard assumption) = €1,100m capital gain.

(Note: many observers believe Cerberus has already achieved most of objective 2. and that the portfolio would today sell for c. £2.2bn (47p in the £1 or a €1,000m capital gain). Over 25% of Project Eagle was land that produced no income. This land (or £300m of the purchase price) would have doubled in value by now. In addition, the portfolio would sell on a yield below 7% today and would probably be generating an income closer to £125m giving a £1.8bn valuation (a £600m uplift). This uplift plus the land, already gives a £900m gain).

6. Cerberus Taxes – £475-618m (if no Section 110 tax avoidance) vs. £0 Actual.

1. A normal Irish Corporate would pay the following taxes on the above income:
   (a) 12.5% Irish Corporate Tax = £106m (£850 x 12.5%)
   (b) 20% Irish Withholding Tax[23] (on post tax profit) = £149m (£850m less £106m x 20%)

These two add up to £255m, or 30% on the £850m in total pre-tax income.

2. A normal Irish Corporate would pay CGT of 20-33% on capital gains:

On £1,100m of capital gains, that equals £220-363m

[23] There is relief against Irish Withholding Tax at a lower 5% rate for owners however this requires the owner to be in a location in which they will pay full home taxes; you cannot get this relief if the loan is offshore.

3. In total, a normal Irish Corporate would pay £475-618m in Irish taxes.

4. Taxes of £475-618m more than match the £440m equity Cerberus invested in Project Eagle

5. Because Cerberus used a Section 110 SPV, it can pay effectively zero Irish taxes.

7. Cerberus Taxes Post Amendment – Still £0.

1. 'Mark-to-market' Relief. A large report could be produced by an accounting firm re-valuing the Project Eagle portfolio to £2.6-3bn based on lower sovereign bond yields (4-5%) and higher land values. This would shelter all future Project Eagle capital gains from Irish taxes into the future.

2. 'Deductibility' Relief. Cerberus could re-structure its £440m PPN Loan. Another report by an accounting firm could state that, given the PPN Loan sits on top of the Bank Debt, it is very risky, and therefore an 'arm's length' interest rate of 18-20% p.a. is justified. This would continue shelter all future Project Eagle income gains from Irish taxes.

CASE STUDY #2: Oaktree €155m acquisition of IBRC Mortgages in 2014

1. Deal Structure (€EURO).

Loan Par Value		€363m
Price Paid		€155m (42 cents in the €1)
Funded by	:	€75m Bank Debt (from Citibank)
		(Note: The bank debt is non-recourse and at a <50% LTV)
	:	€80m Equity (from Oaktree Capital)
		(Note: The equity is structured as a Section 110 PPN Loan)

2. Year 1 Income (from Mars Capital Ireland Section 110 Accounts).

2015 Gross Income	€14m (not including any repayment of principal)
2015 Bank Interest	€3m (3.9% + LIBOR on the Bank Debt)
2015 Pre-Tax Income	€11m (Gross Income less Bank Interest)
2015 Oaktree Interest	€11m (Section 110 PPN Loan interest of 10% + 'Variable'[24])
2015 Taxable Profit	€0m (tax of £250 paid in 2015, which is lost in rounding)

3. Key Distressed Debt Metrics - High Income Yield + Possibility of High Capital Gain.

Start Unleveraged Yield 9.0% (€14m divided by €156m)

Note: this is a typical NAMA / IBRC loan portfolio sales yield – 8-10% unleveraged income.

Start Leveraged Yield 14% (€11m pre-tax income divided by €80m Oaktree equity)

Note: most vulture funds used a 50-60% LTV loan @ 3-4% to double the unleveraged yield, however in this case Oaktree only used a 48% LTV loan, and have a lower leveraged yield

Discount to Par Value 42 cents in the €1 (€155m paid for €363m of loans)

Note: The discount to par value is much less than what Cerberus paid in Project Eagle. However, these are Irish residential mortgages and thus of higher credit grade in terms of Personal Guarantees. These mortgages would have been made in 2004-2006, and being 10 years old, mean their 2015 income of €14m is 'seasoned' (i.e. the income will only improve).

[24] Note Oaktree paid 'internal' fees and expenses in 2015; however in effect, it is all the same.

4. Hypothesised Oaktree Strategy – Let time do the work over next 10-20 years.

Oaktree strategy can be the classic Distressed Debt work-out, but amended for mortgages:

1. Lock down the portfolio for the next 10-20 years and let time fix the asset values;

(Note: While Oaktree's stated strategy is to hold for 10-11 years, it can re-package any outstanding mortgages at the end, and re-sell as portfolio to another buyer.)

2. Ensure that the 14% per annum income comes in over the next 10 years;

3. Check that any borrower who can pay more, does so (i.e. improve 14% per annum yield);

4. Take action on any non-income paying borrowers and recover asset;

5. Give term extensions (5-10 years) as long as the 14% is maintained, to get higher recovery.

(Note: Time is the friend of all Distressed Debt investors, however that is particularly so in the case of mortgages given it is the borrower's own home. US data shows that loan recovery rates for 'well seasoned' loans, can reach +90% after 10 years, and 100% thereafter.)

5. Potential Oaktree Returns – €210m (58% income and 42% capital).

1. 14% per annum on €80m for 11 years = €122m in income.

2. Improve recovery to 65 cents in the €1 (standard assumption) = €88m capital gain.

(Note: while a 50% improvement on recovery rates from what Oaktree paid is a standard Distressed Debt assumption for mortgages, Oaktree also have a stated benchmark return hurdle of 15% p.a. on all investments[25]. This implies that Oaktree expect to get a higher recovery rate on these mortgages of closer to 80 cents in the €1 over next 10-20 years.)

6. Oaktree Taxes – €55-66m (if no Section 110 tax avoidance) vs. €0 Actual.

1. A normal Irish Corporate would pay the following taxes on the above income:

(a) 12.5% Irish Corporate Tax = €15m (£122 x 12.5%)

(b) 20% Irish Withholding Tax (on post tax profit) = €22m (€122m less €15m x 20%)

These two add up to €37m, or 30% on the €122m in total pre-tax income.

2. A normal Irish Corporate would pay CGT of 20-33% on capital gains:

On €88m of capital gains, that equals €18-29m

3. In total, a normal Irish Corporate would pay €55-66m in Irish taxes.

[25] "Oaktree's 15% Returns Target is its lowest ever, Marks says", CEO Marks Bloomberg Interview (Dec 2012).

4. Taxes of €55-66m are close to the €80m in equity Oaktree invested[26]

5. Because Oaktree used a Section 110 SPV, it can pay effectively zero Irish taxes.

7. Oaktree Taxes Post Amendment – Still €0.

1. 'Mark-to-market' Relief. A large report can be produced by an accounting firm re-valuing the mortgages to €280-350m based on lower sovereign bond yields (4-5%) and lower default rates. This should shelter all future Oaktree capital gains (recovery rate of 97 cent in the €1) from Irish taxes.

2. 'Deductibility' Relief. Oaktree could re-structure its £80m PPN Loan. Another report by an accounting firm could state that given the PPN Loan sits on top of the Bank Debt, it is very risky, and therefore an 'arm's length' interest rate of 14-15% p.a. is justified. This will shelter all future Oaktree income gains from Irish taxes.

[26] And remember from earlier, that Oaktree will not meet its benchmark return of 15% IRR on these taxes; it is therefore likely that Oaktree expects a much higher loan recovery rate, and thus its taxes will be closer to €80m

DRAFT AMENDMENT TEXT

X. (1) Section 110 of the Principal Act is amended by inserting the following after subsection (5):
"(5A) (a) In this subsection -

> 'specified mortgage' means any financial asset which derives its value, or the greater part of its value directly or indirectly, from land in the State,
>
> 'specified property business', in relation to a qualifying company, means that part of the business of the qualifying company that involves the holding, managing or both the holding and managing of specified mortgages, including any activities which are ancillary to that business;
>
> 'relevant Member State' means a state, other than the State, which is a Member State of the European Union, or not being such a Member State, a state which is a contracting party to the Agreement on the European Economic Area signed at Oporto on 2 May 1992 as adjusted by the Protocol signed at Brussels on 17 March 1993;
>
> 'specified security' means a security where subsection (4) would, but for this subsection, apply to any interest or distribution payable thereon.

(b) (i) In this paragraph—
'arrangement' includes any agreement, understanding, scheme, transaction or series of transactions;

> (ii) In calculating the portion of the value of a specified mortgage attributable directly or indirectly to land in the State for the purposes of paragraph (a), account shall not be taken of any arrangement that—
>
> (I) involves a transfer of assets from a person connected with the qualifying company, and
>
> (II) the main purpose or one of the main purposes of which is the avoidance of tax.

(c) (i) Notwithstanding the generality of section 70(1), the profits arising to a qualifying company from its specified property business shall be treated for the purposes of the Tax Acts as a separate business which is distinct from any other business or part of a business carried on by the qualifying company.

> (ii) For the purposes of treating the specified property business of a qualifying business as a separate business, in accordance with this paragraph, any necessary apportionment shall be made so that expenses laid out or expended in earning the profits of that separate business shall be attributed to the separate business on a just and reasonable basis and the amount of the expenses so apportioned shall be an amount which would be attributed to a distinct and separate company, engaged in the same activities, if it were independent of, and dealing at arm's length with the qualifying company.
>
> (iii) Subsection (6) shall not apply to the calculation of the profits arising to a qualifying company from its specified property business.

(d) (i) Subsection (4) shall only apply to the calculation of the profits of a specified property business of a qualifying company where any interest or other distribution is paid by a qualifying company to -

(I) a person within the charge to corporation tax in the State in respect of that interest or other distribution,

(II) a fund approved under section 774, 784(4) or 785(5), a PRSA within the meaning of 787A or a person exempt from income tax under section 790B, or

(III) a person who is resident in a relevant Member State under the laws of that Member State (referred to in this clause as the 'non-resident person'), under the laws of which the interest or distribution is subject, without any reduction computed by reference to the amount of such interest or other distribution, to a tax which generally applies to profits, income or gains received in that state, by persons, from sources outside that state where it would be reasonable to consider that—

(A) it would not be reasonable to draw the conclusion that the specified security forms part of any arrangement or scheme of which the main purpose, or one of the main purposes, is the avoidance of a liability to tax, and

(B) genuine economic activities are carried on by the non-resident person in the relevant Member State.

(ii) Notwithstanding the generality of subparagraph (i), that subparagraph shall not prevent the deduction of so much of such interest or other distribution as would be payable under an agreement entered into by way of a bargain made at arm's length and which is not dependent on the results of the qualifying company's specified property business.

(d) This subsection shall apply to profits arising from the specified property business of a qualifying company after 6 September 2016.