STEPHEN DONNELLY TD – RESPONSE TO THE FINANCE BILL, 2016, REGARDING TAX BREAKS FOR COMMERCIAL PROPERTY

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This position paper focuses on commercial property, and is part of a wider response to the Finance Bill, 2016, that includes analysis of proposed changes to Section 110 of the 1997 Taxes Consolidation Act, aimed at curbing tax avoidance by the so-called Vulture Funds.

All tax avoidance described herein, attributable to named and unnamed firms, is believed to be legal. There is no suggestion that any company, 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.

SUMMARY: Proposed new tax breaks on property in the 2017 Finance Bill will fuel an existing commercial property bubble in Dublin, exacerbate economic challenges caused by this bubble, increase the risk of another crash and significantly erode the tax base.

1 Dublin is currently experiencing a commercial property bubble.

1.1 The capital is now the 2nd most expensive commercial property market in the Eurozone.[1] It is also the 6th most expensive market in CBRE's 57 City Commercial Property Survey (CBRE is the world's largest property agent).[2] This is not due to build costs. Major international surveyors provide comparative data showing that Dublin build costs are in line with all 1st World Eurozone Cities.[3] It is also not due to the demographic or geographic pressures faced by some other international cities. Dublin's population density is low, and the city is surrounded by land suitable for development.

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[1] *Appendix 2a: Knight Frank Q2 2016 European Quarterly – Commercial Property Outlook (Top 26 Commercial Property Cities in Europe for Prime Office)*

[2] *Appendix 2b: CBRE Marketview Q3 2015 EMEA (Europe, Middle East and Africa) Major City Commercial Office Survey (Top 57 Commercial Property Cities in Europe, Middle East and Africa for Prime Grade A Office)*

[3] Turner & Townsend International Construction Market Survey 2016" (with European Market Cost annex); "Arcadis International Construction Cost 2016"

1.2 **Grade A Commercial Property in Dublin currently sells for 6.4 times more than it costs to build**. Of the cities analysed by Commercial Agent Knight Frank, only Paris and London have a higher multiple of gross property value to core property build cost. As was the case in Ireland's recent property bubble, which burst in 2007 / 08, the fundamentals determining commercial property values in Dublin today (including cost to build, physical constraints and demographic pressures) do not support these high valuations. Large deviations of property prices to cost of build are a more reliable indicator of property bubbles than yields / affordability analysis. Most major 1st world European cities maintain a multiple of 3.5 - 4.5.

2 This bubble is contributing to significant negative economic effects.

2.1 **Commercial rents in Dublin are too high.** So high, in fact, that commercial rent now ranks as 2nd highest in the Eurozone. Across the EU, only London, Paris, Zurich and Geneva have higher rentals for prime office space. A similar pattern is being seen in prime retail, with rents for shopping centres following the same path as office.[4] The high values on commercial property are driving high land prices (as the cost to build is stable), which is in turn driving high rents (needed to justify the high land prices). And not only are rents high, they're rising rapidly. In the last few years alone they have nearly doubled in Dublin.[5][6] This is causing considerable hardship for businesses, who are seeing their hard-earned profits eroded by higher costs.

2.2 **Residential development is being supressed.** Dublin commercial property is selling for over €1,200 per sq ft, while core Dublin residential property sells for less than half that price (c €500 per sq ft). Therefore, nobody wants to sell or use core land / buildings for residential development. The result is increasing house prices in Dublin, as supply is constrained. Ireland has:

[4] Knight Frank Q2 2016 European Quarterly – Commercial Property Outlook (Top 26 Commercial Property Cities in Europe for Prime Office)

[5] *Jones Lang LaSalle, 2016 Dublin Office Market Outlook, prime rent in Dublin grew from €35 / sq ft to €55-60 / sq ft from Q4 2013 to Q4 2015*

[6] *Sunday Business Post October 9th 2016, 'Peak rate of €65-€70 per square foot are being predicted', referencing Knight Frank as source.*

(a) Very similar wages and salaries as the main 1st world EU countries[7], and
(b) Similar mortgage loan multiples as main 1st world EU countries (3.5 x Salary[8]).

As such, Dublin should have similar residential levels of supply and price to comparable cities internationally. However, because Dublin commercial property prices are so bloated (vs. other EU cities), the residential market – being driven by Wages and Mortgage Loan Multiples – is now depressed, leading to under-supply and higher prices. Thankfully, the Irish Central Bank refuses to "square this circle" by inflating Irish private credit, as happened from 2002-2007.

2.3 Irish banks are being put at risk. Extensive new controls have been put in place since 2008, including in the areas of risk management by the banks and central bank surveillance of the banks. These should reduce both the risk of future bank failures and the damage that such failures can cause. Nonetheless, Irish banks are a major source of financing (and in a normal market, domestic banks are the driving force of any commercial property finance). As such, a sustained bubble in commercial property poses a risk to those banks, and therefore to the wider economy.

3 Irish tax policy is a significant contributing factor to this property bubble.

3.1 Tax breaks on commercial property are already fuelling high demand. Recent changes in tax policy concerning property investments, coupled with innovations in how tax policy is used, are leading to significant tax avoidance in the sector. Other EU countries don't provide such tax avoidance opportunities, so demand from international landlords for Irish (and particularly Dublin) property is high, fuelling value and rents.

3.2 Multiple legal routes for tax avoidance are available.

3.2.1 Section 110 SPVs are being used by so-called vulture funds to avoid paying taxes on profits generated from property-backed loans.[9] However, there are several other legal routes available for property investors.

[7] *"Eurostat Labour & Wage Cost Survey 2016"*
[8] *"ECB Retail Banking in Eurozone Survey 2015"*

3.2.2 Real Estate Investment Trusts, REITs, introduced in the 2013 Finance Act, allow property management and investment companies, "unlike other property companies, distribute their income in a highly tax efficient manner."[10] The REIT structure allows a reduced level of taxes to be paid from the normal tax structure of Irish capital and Irish income taxes. [11]

3.2.3 Qualified Investment Funds, QIFs, (or QIAIFs)[12] allow taxes on profits from property assets be deferred for up to 7 years, with options to avoid all Irish taxes on exit depending on structuring.[13]

3.2.4 Irish Collective Asset-Management Vehicles, ICAVs, introduced in 2015, are another established legal vehicle used by property investors to ensure tax efficiency. ICAVs allow permanent gross roll-up of profits, with options to avoid all Irish taxes on exit (depending on structuring). [14]

3.3 Recent innovations by tax practitioners are helping institutional landlords move from being 'tax efficient' to being completely tax free. While the secrecy enjoyed by ICAVs and QIAIFs has helped them structure their affairs to avoid Irish taxes on exit, more recent 'innovations' by tax practitioners have employed the most powerful tax avoidance vehicle in Ireland, the Section 110 SPV, into ICAVs and QIAIFs. This has

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[9] See other policy papers by author on Section 110 SPV use by so-called vulture funds (e.g., '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).

[10] *Zurich: Understanding Irish Real Estate Investment Trusts*

[11] 'Before the introduction of REITs, investment in property via corporate vehicles was not generally a tax-efficient option, due to the double layer of taxation that applies to profits earned in a company and then paid out to shareholders in the form of dividends. Corporation tax at the higher, non-trading, rate of 25% is payable by companies on rental profits, and shareholders are liable to income tax at marginal rates on dividends paid from the after-tax profits of the company.' From Department of Finance, Real Estate Investment Trusts (REITs): Tax Policy Rationale available here: http://taxpolicy.gov.ie/wp-content/uploads/2013/06/E3_DeirdreDonaghy.pdf

[12] Qualifying Investor Alternative Investment Funds

[13] A QIF has a distinct tax treatment to that of other companies and individuals holding property. A QIF is not subject to any tax on its rental income or on any gains on disposal of assets. Instead the QIF must operate an exit tax on the happening of certain chargeable events.
Source: William Fry, available here: http://www.williamfry.com/newsandinsights/news-article/2011/11/29/qualifying_investor_property_funds

[14] 'The ICAV is treated, for Irish tax purposes, as a corporate vehicle which is fully exempt from Irish tax on its income and profits. In other words, there is no fund level taxation of the ICAV.' Source: Matheson, The ICAV – Frequently Asked Tax Questions, available here:
http://www.matheson.com/images/uploads/publications/ICAV_Frequently_Asked_Tax_Questions.pdf

given rise to the so-called Orphan Super QIF, whose ability to avoid all Irish taxes, VAT and Stamp Duties on Irish property is unparalleled in Irish tax history.[15]

4 The Finance Bill, 2016, contains new tax breaks that will make commercial property in Ireland tax free for foreign and domestic landlords and investors, who make up the vast majority of commercial property ownership in Ireland.

4.1 International landlords are the main buyers. The era of the so-called vulture funds is coming to an end as the ECB's negative yields policy has made most EU real estate too expensive for them. Over 80%[16] of all future Irish Commercial Property investment will come from foreign Pension Funds, Life Assurance Funds other Collective Investment Undertakings, CIUs ((CIUs covers a wide range of REITs, unit funds and trusts, mutual funds, UCITs, and almost any other investment structure and institutional investor would use).[17]

4.2 The Finance Bill provides these investors with full tax free status. The new section in the Finance Bill on Irish Real Estate Funds, IREFs, provides full exemption from Capital Gains Tax, CGT, once investors hold the property for at least five years.[18] The section on IREFs goes on to apply a 20% Dividend Withholding Tax, DWT, but it excludes all of the above investor types from this tax. There are no other Irish taxes to be paid.

4.2.1 Irish pension funds are already exempt from taxes in Ireland, and it is not proposed that this be changed. However, notwithstanding some exceptions, Irish Pension Funds

[15] The typical Super QIF structure usually involves a QIF establishing a Section 110 Company as its 100% subsidiary. The proceeds raised from issuing shares/units in the QIF to investors are then used to fund the Section 110 Company by acquiring profit participating loan notes ('PPNLs'). The Section 110 Company then acquires all or some of the desired underlying assets. The PPNL provides the QIF with interest payments which effectively match the performance of the underlying assets (less appropriate operating expenses and small profit margin). Where the QIF is an umbrella fund, multiple Section 110 Companies can be used to hold the relevant assets for each sub-fund. Breaking the equity relationship between the QIF and the Section 110 Company may provide additional flexibility to the structure whilst maintaining all of the tax efficiencies
Source: Davy, Ireland as a Location for Distressed Debt Funds, available here: https://www.scribd.com/document/321040583/Ireland-as-a-Location-for-Distressed-Debt-Section-110-QIF-Super-QIF-Davy-Stockbokers

[16] *"CBRE Investment Digest H1 2016"*, it was 70% for deals over €1m, but 80% for deals over €10m.

[17] Pension Funds (e.g., German BVK, Canadian PPIB), Life Assurance Funds (e.g., Aviva, M&G, Allianz), Collective Investment Undertakings (e.g., Hines, Hammerson).

[18] Finance Bill, 2016, 2nd Stage, Page 41

don't get exemptions from taxes when they invest in most other countries. Generally, countries don't give tax breaks to each other's pension funds, and most DWT cannot be reclaimed. It is unclear, then, why Ireland would now choose to give such tax breaks to foreign Pension Funds investing here.

4.2.2 Similarly, **Irish Life Assurance** companies were never exempt from Irish taxes. They do make use of tax deferral mechanisms such as Unit Funds, but full taxes are paid at exit from those schemes. The Finance Bill, 2016, would exempt all Irish and foreign Life funds from taxes on property. Again, it is unclear why this is being proposed.

4.3 **The result is that the vast majority of commercial property investors will operate in Ireland exempted from all income / rental taxes and capital gains taxes**. The profits on their Irish assets will roll up gross in QIFs (or QIAIFs) or ICAVs, shielded from public scrutiny. They will get CGT relief when they liquidate (after a 5 year hold), and they are exempt from withholding tax. The author is unaware of any other EU countries were Pension Funds, Life Funds and other CIUs are exempted from all taxes on Commercial Property.[19]

5 The Finance Bill, 2016, also provides a new and powerful path to avoiding Irish taxes on profits from domestic loans of almost any type, and has the potential to fuel new credit risks.

5.1 **Taxes on profits from commercial and residential mortgages, and other loan types, may now also be avoided.** The Finance Bill, 2016, excludes ‘specified property businesses’ from using Section 110 to avoid taxes. This is welcome, and is being done to shut down tax free status to so-called vulture funds. However, the Bill still allows Section 110 status for several important asset classes, as follows:

(i) Collateralised Loan Obligations, CLO;

(ii) Residential Mortgage-Backed Securities, RMBS;

(iii) Commercial Mortgage-Backed Securities, CMBS;

[19] *“Insights on Real Estate Investment Trusts”* KPMG February 2015

(iv) Loan Origination Business, LO.

It takes about two weeks, and less than a few thousand euro in fees, to convert any Irish loan over €200,000 into a listed CLO / CMBS / RMBS / LO compliant transaction.[20] This is one of several loopholes still available to so-called vulture funds to continue to operate tax free.[21] However, it also means that most major Irish domestic lending (property and non-property) will have the option to become effectively exempt from all Irish taxes. Irish and foreign banks could, should they choose, begin to re-route their lending through CLO / CMBS / RMBS / LO tax-free vehicles. This would remove the traditionally largest corporate tax payers from the Irish tax base.

5.2 **There is also a serious new risk to the Irish Financial System**. When a country allows external credit instruments like CLO / CMBS / RMBS / LO into its market, it temporarily inflates the value of its assets (which for Irish Commercial Property, are already at bloated levels), as new, cheap foreign credit arrives. However, in any credit shock (domestic or global), the withdrawal of these credit instruments (i.e., the withdrawal of the credit flow) causes exaggerated asset price collapses which can break the Financial System. We saw this first hand in the Irish credit crisis, when EU Banks stopped providing liquidity to Irish Banks (in an almost identical structure to the above credit instruments). This is very dangerous.

6 The Finance Bill, 2016, needs to change tax policy to address the commercial property bubble, secure exchequer revenues from the domestic tax base, and improve transparency.

6.1 **Recognise this 'Reverse FDI'**: Why is the Finance Bill effectively removing Irish Commercial Property, one of the largest asset classes in the State (if not the largest), from the Irish domestic tax base? Is this not confusing foreign Commercial Property purchases with multi-national Foreign Direct Investment, FDI? In fact, allowing foreign funds (of any type) to buy Irish Commercial Property free of all Irish taxes is more akin to Reverse FDI. For a temporary deposit of capital by the foreign purchaser,

[20] "*Listing Debt Securities on the Irish Stock Exchange*", McCann Fitzgerald 2015

[21] See other policy papers by author on Section 110 SPV use by so-called vulture funds (e.g., '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).

they export Irish rental income and Irish capital gains – gross – to other locations. Eventually the foreign purchaser sells to a domestic Irish purchaser (ironically, at a higher price, and with Irish bank debt), and their FDI is gone.

6.2 **Protect the Irish domestic tax base**: By creating these tax loopholes, the Finance Bill would significantly erode the domestic tax base. This is in spite of repeated government assurances, backed up by expert advice, that one way for Ireland to avoid another crash is to widen the tax base. Given the pressures from Irish public sector wage demands and public sector pension deficits, there is little scope that the other tax sources, on their own, can produce sufficient public monies to meet the huge capital deficit that we have in our schools, hospitals, and other public services. Perhaps this is why ALL other EU countries:

(a) Tax income and capital gains on commercial property (regardless of the status of investor), and

(b) Tax commercial lending activities (they don't allow un-restricted use of CLO / CMBS / RMBS / LO in exporting domestic interest payments offshore).

6.3 **Halt the trend in a generationally divided society**: Asset bubbles work for those who own the assets, and against those who do not. We experienced this in the previous bubble, which saw a large transfer of wealth from younger to older generations. We are seeing it again now, with younger families, and the negative equity generation (the younger families of the last bubble), unable to buy homes. This is in part because they are competing with international landlords, with deep pockets, who are operating in a highly tax efficient manner.

This is the new Irish generational divide. In taking commercial property out of the tax net, this Finance Bill not only fails to address the current asset bubble, it will make it significantly worse. This will further divide Irish society between the owners of assets and everyone else, forced to take on higher and higher debt in order to achieve home ownership.

6.4 **Remove 5 year CGT exemption and properly tax Irish Commercial Property**. There is no justification for such a tax break for investors in Irish commercial property. It is particularly worrisome given the current commercial property bubble in Dublin. Individuals, and other companies in Ireland, pay CGT at the full rate - the same should be the case in the property sector (not least because it is probably Ireland's largest asset base).

6.5 **Remove DWT exemptions for funds.** While the existing tax status for Irish Pension Funds can be maintained, new exemptions should be not provided to foreign funds, or to the additional domestic and foreign funds listed for exemption, including Life Assurance funds and Collective Investment Undertakings.

6.6 **Remove Section 110 status for assets that derive their value, or a substantial part of their value, from economic activity based in the State.** Section 110 was developed to facilitate global securitisation business. As government has stated, it was not designed to avoid taxes on profits coming from economic activity in the domestic economy. However, as legal and financial advisors have shown, Section 110 can be used in creative ways, combined with other legal mechanisms, to create tax-free status where such status was not intended.

The Finance Bill, 2016, makes genuine attempts to shut down Section 110 tax avoidance by the so-called vulture funds. However, anecdotal evidence provided to the author includes numerous paths that legal and financial experts have already identified, to ensure their clients continue to pay minimal taxes on huge profits generated in the domestic economy.

Once a tax free mechanism is allowed exist in the domestic economy, experts will find ways to use it. The only way of truly stopping such activity, therefore, is to fully remove Section 110 from being used for any assets (e.g., mortgage books) that derive their value from economic activity in the State (e.g., people paying their mortgages in Ireland).

6.7 **Mandate all Irish companies, paying reduced Irish taxes, to file publicly accessible accounts with the Companies Registration Office.** It is hard to see a justification for an investor (foreign or domestic) paying zero Irish taxes and being given privacy from public scrutiny. These are the techniques of a Tax Haven, and we are not a Tax Haven. It was only because the so-called vulture funds, using Section 110 Special Purpose Vehicles, had to file publicly accessible accounts, that politicians and journalists were able to uncover what was going on. Such scrutiny should be a basic right for the public.

6.8 **Remove the exemptions for CLO / CMBS / RMBS / LO transactions.** Unrestricted use of these new credit instruments will wreak even greater destruction on the Irish tax base. Use of temporary external capital instruments to artificially further inflate Irish asset prices will also re-create the conditions that led to the collapse of the Irish Financial System in 2008-12. Any use of such credit instruments requires a longer and more considered discussion with the ECB, Irish Central Bank and other Risk Experts. They should not be allowed at the behest of lobby groups.