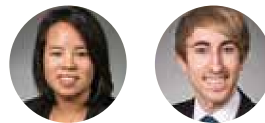
Analysis

Credit funds: A taxing proposition



Guest comment by **Serena Lee** and **Matthew Durward-Thomas**

Complying with tax rules can make setting up private debt funds a complex task, but there are ways to navigate the maze

Credit funds continue to grow as they take on an ever-broader range of financing roles. However, there are several tax rules that can create traps for the unwary, and affect fund returns, investors' tax treatment and, ultimately, the optimal fund structure. While the partnership structure is familiar to investors, it may not be the most efficient.

Withholding tax – the key issue

The primary tax consideration is whether payments received by the fund will be subject to withholding tax. This is less of a concern for listed investments (which often benefit from withholding tax exemptions) and distressed investments (if material interest payments are not expected) but will often be relevant to direct lending funds.

Where withholding tax is relevant, investments are often held through a treaty-eligible corporate entity to mitigate such taxes. However, many jurisdictions will deny treaty benefits where it is reasonable to conclude that obtaining the treaty benefit was a "principal purpose" of the arrangement that resulted in that benefit.

The EU has also proposed a new "unshell" directive (ATAD 3), which seeks to discourage the use of EU-based entities with little or no economic activity. In practice, this means it is important to evidence good commercial reasons for interposing a holding company. Further, a certain level of "economic substance", in the form of employees, office space and resources will typically be required. As a result, credit funds are increasingly establishing investment platforms in jurisdictions like Luxembourg and Ireland where they have already developed material substance or intend to do so.

Asset holding companies – or new fund vehicles?

The problem with inserting a company into a fund structure is that it introduces a variety of tax issues. Historically, the choice has been between a Luxembourg Sàrl or an Irish Section 110 company, each funded with profit-participating debt that effectively strips out all the company's taxable income save for a small margin (which is taxed at the prevailing corporate tax rate). However, EU member states have introduced rules limiting a company's ability to do this, in order to comply with European anti-tax-avoidance directives (ATAD 1 and 2).

In particular, "anti-hybrid" rules

can counteract tax benefits arising from the use of hybrid instruments (ie, those treated as debt in one jurisdiction, but equity in another) or hybrid entities (ie, those regarded as transparent in one jurisdiction, but opaque in another). This is particularly problematic for funds with US investors, which typically treat profit-participating debt as equity, and may benefit from US "check the box" elections that result in fund entities becoming hybrid entities. The application of anti-hybrid rules can result in tax deductions being denied, or income being deemed to arise at the borrower and/or holding company level.

Interest limitation rules also restrict a company's ability to offset tax-deductible interest expense against anything other than interest-like income. This is less of an issue for direct lending strategies where returns are interest-like but has been particularly problematic for distressed strategies where returns are typically in the form of gains realised over the acquisition price.

As an alternative, many fund managers are choosing to set up credit funds using tax-exempt regulated entities, such as the Luxembourg Reserved Alternative Investment Fund and the Irish Collective Asset-Management Vehicle. While this brings increased cost and regulatory oversight, it considerably simplifies the fund's tax treatment. And, while it may still be necessary to introduce another entity below the fund entity (as, for example, not all jurisdictions consider an ICAV to be treaty eligible), the "principal purpose" analysis tends to be easier to apply in a structure headed by a regulated European fund entity.

The UK's future alternative?

The UK government has recently introduced a new "qualifying asset holding company", which provides a genuine alternative to Ireland and Luxembourg. Tax benefits include:

1 The ability to benefit from tax deductions on profit-participating debt (without the issues for distressed debt discussed in this article);

2 The ability to rely on a domestic withholding tax exemption for UK loans (avoiding the need to make treaty relief claims or rely on the UK's qualifying private placement regime);

3 An exemption from the obligation to withhold tax on interest paid on most loans issued to its investors;

4 A partial exemption from the anti-hybrid rules.

5 Using a UK-based entity may also make it easier for credit funds with a UK manager to satisfy any substance requirements.

Loan origination and the investment manager exemption

Most credit funds with a UK manager rely on the "investment manager exemption" to ensure the UK manager's activities do not cause fund investors to become subject to UK tax solely as a result of their investment in the fund.

However, the investment manager exemption only applies in relation to investment transactions. HMRC takes the view that taking a lead in arranging a syndicate to advance a loan, acting akin to a placement agent (ie, originating a loan where the fund is not lending), or managing such loans are not investment transactions for these purposes. As such, any remuneration received from such activities would not benefit from the exemption. Fund managers seeking to expand their role in the direct lending space should therefore be careful that new activities do not endanger their wider tax structuring.

Carried interest considerations

Credit funds with carried interest structures managed from the UK may also face additional complications, thanks to the Income Based Carried Interest rules. Where these apply, amounts that would historically have been taxed as carried interest (and subject to lower capital gains tax rates) are taxed at income tax rates under the Disguised Investment Management Fee rules.

The IBCI rules are (predictably) complex but, broadly, can kick in where a fund's "weighted average holding period" of its investments is less than 40 months, or if the fund is a "direct lending fund" – an investment scheme for which it is reasonable to suppose that, when the investment period ends, a majority of the investments (by value) will have been direct loans made by the scheme – unless certain exceptions apply.

However, the IBCI rules do not apply to an individual who is subject to the Employment Related Securities rules, which would generally apply, for example, to employees and directors of fund entities in the UK.

This somewhat unusual quirk of the UK rules means that, in some instances, employees of an investment manager may be taxed on their carried interest at more favourable rates than if they were partners in a manager constituted as an LLP. ■

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