Private Credit Funds: Conquering Tax Challenges for Foreign Investors: Session I: Overview and Practical Considerations

July 14, 2020

Session II: Common Strategies (Leverage Blocker, Season & Sell, and Treaty) – Thursday, July 16, 2020

Session III: Less Common Strategies (REITS, IDFS, and more) – Tuesday, July 21, 2020

PRIVATE CREDIT - A COMPELLING STRATEGY, NOW MORE THAN EVER

- Private credit has over the past several years been one of most attractive asset strategies for institutional investors.
- Recent events are driving demand for private credit even higher.
- Many private credit strategies involve the origination of loans by U.S.-based fund sponsors.
- At the same time, private credit attracts strong interest from foreign investors that require solutions to U.S. tax challenges.
- Deploying foreign capital in private credit on a tax-efficient basis requires thoughtful structuring solutions and careful planning.

Key Tax Considerations for Foreign Investors

KEY TAX CONSIDERATIONS - EFFECTIVELY CONNECTED INCOME

General Summary of the ECI Issue

- If a foreign investor is engaged in a U.S. trade or business (directly or indirectly), the foreign investor is required to file a U.S. federal income tax return and pay tax at the same rates applicable to U.S. taxpayers on any income they derive that is treated as effectively connected with the U.S. trade or business (effectively connected income, or ECI).
- Consequences of earning ECI:
  - The foreign investor must file a U.S. federal income tax return and pay income tax on the ECI.
    - Foreign corporations, like U.S. corporations, are subject to tax on ECI on a net basis (i.e., net of applicable deductions and credits). However, if a foreign corporation fails to file a U.S. federal income tax return, the foreign corporation would lose the right to take deductions and credits against the ECI (i.e., if the IRS were to later audit and assess tax). There is no applicable statute of limitations for the IRS to assess tax on a taxpayer who fails to file a return.
  - In the case of a foreign corporation, an additional 30 percent branch profits tax might be imposed.
  - A foreign investor may also be subject to state and local income taxes in applicable jurisdictions.

KEY TAX CONSIDERATIONS - SECURITIES TRADING SAFE HARBOR

General Rule on U.S. Trade or Business – Facts and Circumstances

- Generally, whether a foreign investor is considered to be engaged in a U.S. trade or business is determined under a facts and circumstances analysis based on both the type and the frequency of the activity conducted by a foreign investor in the United States.

Securities Trading Safe Harbor

- A foreign investor is generally not treated as being engaged in a U.S. trade or business for U.S. federal income tax purposes if the foreign investor's activities are limited to those that qualify for what is known as the "securities trading safe harbor."
- The safe harbor would apply to an investor trading or investing for its own account or through an agent such as an investment manager. The number and size of trades is not limited; foreign investors with significant trading activities can take advantage of the safe harbor.
- The purchase of a fully funded loan (secondary market acquisitions) should normally fall within the securities trading safe-harbor absent additional facts that the foreign investor was involved in arranging or making the loan.

Mere Investing

- "Mere investing," even if the resulting investments require significant oversight/management activity, is also generally not a U.S. trade or business.

KEY TAX CONSIDERATIONS - LOAN ORIGINATION

Loan Origination Activities Expose Foreign Investors to ECI Risk

- Loan origination activities (e.g., directly negotiating with and lending to borrowers) by a foreign investor (either directly or through an agent) do not generally qualify for the securities trading safe harbor and may cause the foreign investor to be deemed to be engaged in a U.S. trade or business. Of prime importance in this regard is the number and frequency of loans made. While there is no bright-line rule, generally only 3–5 loans in a given year presents less risk. Other factors include:
  - (i) amount of time and effort spent on financing or lending activities; (ii) whether the taxpayer has "customers" for its financing or lending activities; (iii) whether the taxpayer participates in loan negotiation activities; (iv) whether the taxpayer holds itself out to the public as being in a lending or financing business; (v) the financing or lending activities of employees or other agents; and (vi) whether the taxpayer maintains an office for the purpose of engaging in financing or lending activities or books and records reflecting the taxpayer's financing or lending activities.

KEY TAX CONSIDERATIONS - DISTRESSED DEBT

Distressed Debt Workouts Expose Foreign Investors to ECI Risk

- Distressed debt funds frequently acquire debt of distressed issuers in contemplation of restructuring the debt, which may involve modifying the debt or exchanging it for other debt or equity.
- Unlike a typical debt investor, a distressed debt fund relies on its skill in navigating the workout process in order to make money.
- It is unclear whether distressed debt investing would qualify for the “mere investing” or “securities trading safe harbor” exceptions to ECI.

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KEY TAX CONSIDERATIONS - FINDING THE RIGHT SOLUTION

- ***Manage ECI risks to pursue better after-tax returns for foreign investors in funds with loan origination and/or distressed debt workout strategies!***
  - **Season and Sell**: Strategy appropriate for managers willing to abide by and able to implement robust operating guidelines. Need source of cash to initially originate loans.
  - **Treaty**: Strategy appropriate for more established managers, ideally managing multiple funds and/or separately managed accounts. Requires right set of facts for treaty qualification. Over the last few years, because of lack of operational restrictions compared to season and sell and U.S. tax efficiencies, often the preferred choice with the right facts.
  - **Leveraged Blocker**: Easiest strategy to implement but likely results in highest U.S. tax cost.
  - **REIT Fund**: Appropriate for loan strategies secured by real estate.
  - **Insurance Dedicated Fund**: Appropriate for US taxable investors, non-US sovereign investors and non-US investors in jurisdictions with insurance-favorable tax treaties.

UPCOMING SESSIONS

- Session II: Common Strategies (Leverage Blocker, Season & Sell, and Treaty) – Thursday, July 16, 2020, 2:30 p.m. ET

- Session III: Less Common Strategies (REITS, IDFS, and more) – Tuesday, July 21, 2020, 2:30 p.m. ET

K&L GATES AND PRIVATE CREDIT

- **PRIVATE CREDIT – COHESIVE SOLUTIONS FOR GLOBAL MANAGERS**
- From fund formation to every kind of lending transaction, working with our global team of tax and regulatory experts we provide solutions and serve as effective partners every step of the way.

- **PRIVATE CREDIT FUND FORMATION**
- We provide solutions that minimize tax and operational burdens while maximizing investor appeal. Our work benefits from our long relationships with a broad array of sponsors; our deep bench of experienced investment management lawyers, including those with in-house and regulatory experience; and our intimate familiarity with the needs and concerns of leading institutional investors.

- **PRIVATE CREDIT FINANCE CAPABILITIES**
- Our private credit lawyers advise private equity funds, as both lenders and borrowers, on the full spectrum of secured and unsecured commercial lending transactions, including secured, unsecured, asset-based, cash flow, unitranche, second lien, holdco notes, and mezzanine debt. We advise on all aspects of the capital structure including negotiating senior secured and unsecured syndicated, club, and bilateral credit facilities and asset based loans. We also represent clients in mezzanine finance transactions that typically involve complex intercreditor and equity holder arrangements. We routinely assist clients with equity-linked return enhancements, including warrants, convertible notes, and direct equity co-investments. We deal regularly with complex intercreditor and equity holder arrangements in these transactions and offer clients a keen market awareness of differing standards and market trends for debt and lien subordination terms.

- **GLOBAL REACH**
- K&L Gates is one of the largest law firms in the world with more than 40 offices located in key commercial and financial centers across five continents. Our broad platform of more than 1,800 lawyers offers clients local market knowledge coupled with the breadth and depth of experience of a truly global firm.

Private Credit Funds: Conquering Tax Challenges for Foreign Investors: Session II: Common Strategies (Leverage Blocker, Season & Sell, and Treaty)

July 16, 2020

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Leveraged Blocker Structure

LEVERAGED BLOCKER

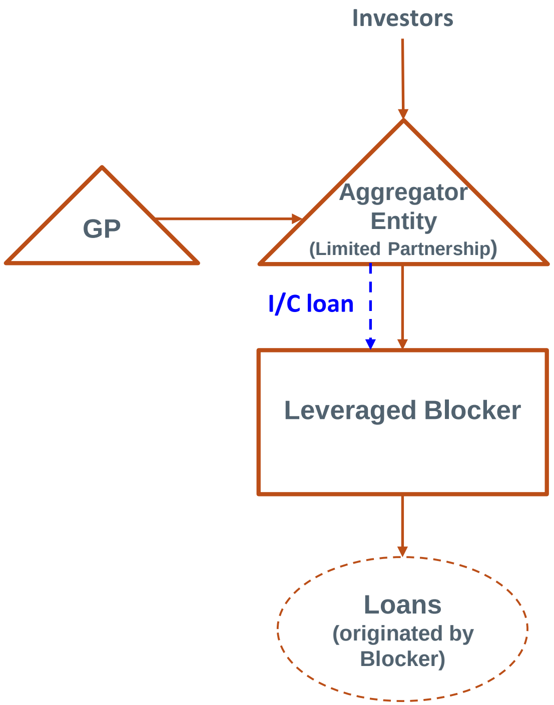
- While easier to implement than the other structures, a leveraged blocker will likely result in the highest U.S. tax cost compared to other strategies discussed herein.
- A leveraged blocker is classified as a corporation for U.S. tax purposes, and therefore any loan origination activities undertaken by the leveraged blocker are not attributed to foreign investors. Foreign investors may invest in the leveraged blocker directly or through an aggregation vehicle such as a limited partnership.
- The leveraged blocker must pay U.S. federal and state income taxes on its net taxable income, after taking any available deductions for interest on the investor debt and other expenses. The leveraged blocker can therefore likely reduce, but not entirely eliminate, U.S. tax leakage. The actual effective U.S. tax rate for a leveraged blocker structure will depend on various factors including income and cash-flow projections for the investment.
- Leveraged blockers are capitalized with both equity and debt, and therefore a foreign investor may receive its return on investment from the leveraged blocker in the form of both distributions and interest payments.
  - Interest payments are not subject to U.S. withholding tax if received by a foreign investor that owns, directly or indirectly, less than 10 percent (by vote) of the leveraged blocker; otherwise, interest is generally subject to a withholding at a rate of 30 percent (unless reduced by treaty). Certain investors, such as sovereign wealth funds, may nevertheless be exempt.
  - Dividend distributions from a leveraged blocker are generally subject to a 30 percent U.S. withholding tax applicable to corporate dividends when paid to foreign investors, unless reduced by a treaty. Sovereign wealth funds may be eligible for 0 percent withholding tax.
    - However, liquidating distributions generally are not subject to U.S. federal withholding tax.
- The ratio of equity to debt, and the terms of the debt investment, must reflect arms-length principles, which typically are determined in consultation with tax and/or economic advisers.

ILLUSTRATIVE EXAMPLE: LEVERAGED BLOCKER

1) Leveraged Blocker is classified as a corporation for U.S. tax purposes, so loan origination activity is not attributed to Investors.

2) Leveraged blocker is capitalized with equity and debt (either from Investors or a third-party lender). Interest may qualify for portfolio interest exemption, dividends from operating income generally subject to 30 percent withholding tax, unless reduced by treaty.

3) Leveraged blocker is subject to U.S. federal and state income taxation on any net income, after taking account of deductions for interest and other expenses.



Season and Sell Strategy

SEASON AND SELL

- The premise behind "season and sell" is that a U.S. entity originates loans and then sells the loans to the foreign investor. The U.S. entity originates the loans on its own behalf, and not as an agent of the foreign investor.
- In a typical "season and sell" structure, the fund platform is organized as a series of at least two parallel funds—"Onshore" and "Offshore" — both typically run by the same manager:
  - **Onshore.** The Onshore fund is typically a Delaware limited partnership or LLC, and investors are typically limited to U.S. taxable investors, non-UBTI-sensitive U.S. tax-exempt investors (e.g., a supertax-exempt investor), and the occasional foreign investor investing through U.S. branch or subsidiary.
  - **Offshore.** The Offshore fund is typically a Cayman Islands entity treated as a corporation for U.S. tax purposes. The Offshore fund typically operates pursuant to robust and comprehensive tax guidelines (see samples on following slide) developed by the fund sponsor and tax advisors in such a way to mitigate the risk that the Offshore fund would be engaged in a U.S. trade or business.
  - In lieu of a separate onshore fund, large asset managers with proprietary trading desks may originate the loans on their own behalf (i.e., serve as the seasoning vehicle).
- The Onshore fund undertakes all loan origination activities (including finding, structuring, negotiating, and funding all loans), and receives all fees for those activities. The Onshore fund then carries the loan for some stated minimum period (e.g., 30 days to 6 months)—the "seasoning period." At the end of the seasoning period, the Onshore fund can offer the loan (or part of it) for sale to the Offshore fund, and the Offshore fund can buy it at price that reflects prevailing market conditions at the time of the participation, not at the time of origination, in a transaction that has been approved by an independent investment professional not affiliated with the fund's origination activities.
  - It is important that Offshore fund does not have the obligation to purchase the loan at the time the loan is originated and may be helpful if the Onshore fund offers the loan to be purchased by other third-parties.
  - The Onshore fund should be able to independently carry all of its positions during the seasoning period without credit support from Offshore.
  - Typically, the Onshore fund will realize gain or loss on the sale and would generally receive some interest income during the seasoning period.

SEASON AND SELL (CONT'D)

- The Offshore fund may have significantly larger commitments compared to the Onshore fund and may not be able to originate loans independently, consistent with the funds' investment strategies. In such a case, a variation of the season-and-sell strategy may be used under which a captive U.S. finance company treated as a corporation is used to originate loans. The captive finance company may be capitalized with equity and permanent debt that is not traced to any single investment. The seasoning process of the finance company would be similar to a typical season-and-sell strategy with the end result being that the finance company eventually sells loans to the Offshore fund.
- **Tax guidelines should be robust, comprehensive, and regularly monitored. Sample provisions in tax guidelines to ensure that the Offshore fund will not be engaged in a U.S. trade or business:**
  - Ensure that the Offshore fund is not be regarded as making loans or devoting a significant amount of time to financing or lending activities by virtue of their own activities with respect to the loans.
    - The Offshore fund will acquire loans only by assignment, secondary purchase, or participation. Thus, the Offshore fund will not originate loans.
    - The Offshore fund also will not be a signatory or party to or negotiate any loan document.
  - Ensure that Offshore fund is not regarded as having customers.
    - The Offshore fund is prohibited from entering into contractual arrangements with borrowers (such as a loan commitment) or negotiating loan terms except in certain limited circumstances in connection with a modification.
    - The Offshore fund is prohibited from performing services or having or seeking customers.
  - Ensure that the Offshore fund avoids other indicia of lending activity.
    - The Offshore fund will not hold itself out to the public as a bank or financing company or register or take any other action to be so treated.
    - The Offshore fund will not devote personnel and office space to lending or financing activities (except as permitted under the tax guidelines)
    - The Offshore fund's books and records will be consistent with the foregoing provisions of the tax guidelines.

ILLUSTRATIVE EXAMPLE: SEASON AND SELL - PARALLEL FUNDS

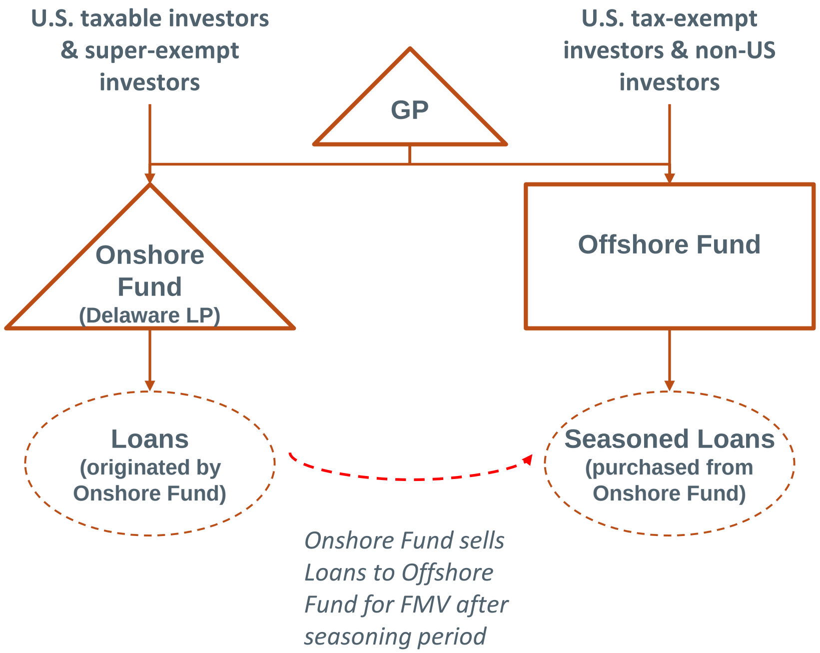
1) Onshore fund undertakes all loan origination activities.

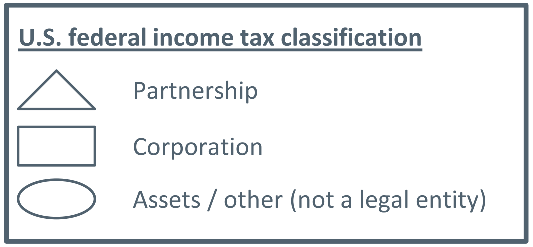
2) Onshore fund carries loans for minimum seasoning period (typically 30 days to 6 months).

3) After seasoning period, Onshore fund offers loans for sale to Offshore fund at then-FMV.

4) An independent investment professional at the Offshore fund determines whether the Offshore fund will purchase the loans.

5) Investment returns and risks (e.g., during economic downturn) will differ between the Onshore and Offshore funds.





ILLUSTRATIVE EXAMPLE:
SEASON AND SELL - CAPTIVE FINCO

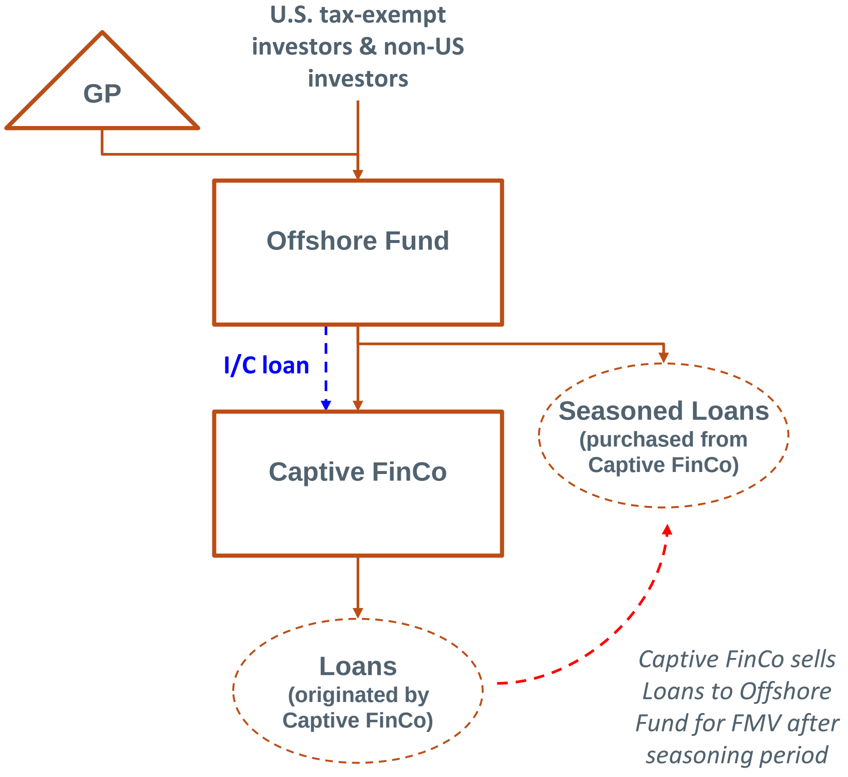
1) Captive Finco undertakes all loan origination activities.

2) Captive Finco carries loans for minimum seasoning period (typically at least six months).

3) After seasoning period, Captive Finco offers loans for sale to Offshore fund at then-FMV.

4) An independent investment professional at the Offshore Fund determines whether the Offshore Fund will purchase the loans.

5) Seasoning guidelines are more robust than the parallel fund structure. Furthermore, Captive FinCo should have permanent capital and/or access to third-party credit line.



Treaty Strategy

TREATY STRATEGY

- Under a treaty strategy, the investment manager typically originates loans in the United States on behalf of an investment vehicle that qualifies for the benefits of a double taxation treaty with the United States (*e.g.*, an Irish fund).
- Most income tax treaties exempt business profits from source-country taxation so long as these items are not attributable to a “permanent establishment” (PE) in the source country. For these purposes, a PE is generally a branch, office, or other fixed place of business.
  - The result of qualifying for a treaty is that a fund that does not have a PE may be exempt from U.S. federal income tax if the fund is a resident of an applicable treaty jurisdiction and does not have a PE in the Unites States, even if the fund carries on activities that constitute a trade or business in the Unites States.
- The PE of an agent (such an investment manager) is typically attributed to a principal (such as a fund). However, if the investment manager is an independent agent (as defined by the relevant income tax treaty), its activities should not cause a foreign treaty qualified person to be subject to U.S. federal income tax on a net income basis, although state taxes may still apply.
  - The investment manager generally must be “legally” and “economically” independent of the principal and acting in the ordinary course of its trade or business. While this requires a detailed analysis, as a general matter:
    - **Legal Independence** requires that the agent be responsible to the principal for the results of its work, but not subject to significant control with respect to the manner in which that work is carried out.
    - **Economic Independence** requires that the agent generally will bear entrepreneurial risk.
  - Generally, large established managers can satisfy the legal and economic independence tests whereas start-up managers cannot.

TREATY STRATEGY (CONT'D)

- Treaty qualification also generally depends on ownership of a fund. In most cases the fund will need to comply with the treaty's "limitation on benefits" clause, which limits treaty shopping by foreign investors who set up entities in the residence country.
  - Funds whose owners are U.S. residents, residents in countries that have a treaty with the United States, or are residents in the EU or in NAFTA countries, are more likely to qualify under an applicable limitation on benefits provision than funds whose owners are not so resident.
  - For example, under the derivative benefits test, a company will generally be entitled to benefits under a treaty if (among other requirements) a specified percentage of its shares is owned, directly or indirectly, by persons who would have been entitled to equivalent or more favorable treaty benefits if they had derived the relevant income directly.
- Common treaty jurisdictions for such a fund are Ireland and Luxembourg.
- A fund-of-one may similarly work for foreign resident of an applicable treaty jurisdiction such that a separate treaty qualified vehicle may not be required. For example, a fund-of-one may be organized on behalf of a European pension plan that is eligible for treaty benefits between the United States and its resident country.
- U.S. states are not required to follow U.S. income tax treaties. As such, state taxation and tax filing obligations may still arise.

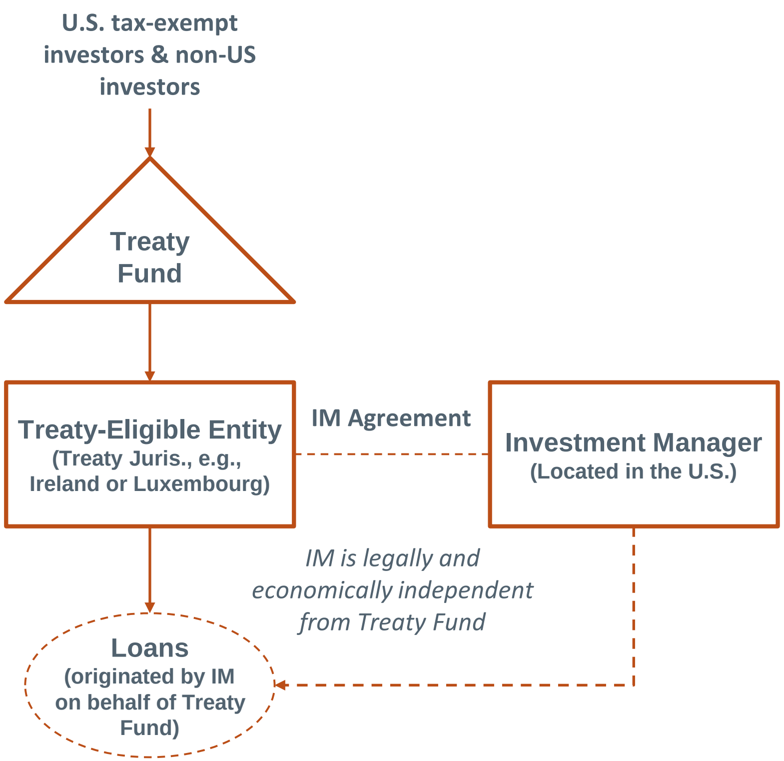
Illustrative Example: Treaty Strategy

1) Investment Manager (that is legally and economically independent of the Treaty Fund) originates loans on behalf of the Treaty-Eligible Entity.

2) Treaty-Eligible Entity is a "resident" of the Treaty Jurisdiction.

3) Treaty-Eligible Entity satisfies the applicable limitation on benefits test.

   - For fund-of-one structures, look to the jurisdiction of the ultimate investors to qualify for treaty benefits.



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Private Credit Funds: Conquering Tax Challenges for Foreign Investors: Session III: Less Common Strategies (REITS, IDFS, and more)

July 21, 2020

REIT Funds

REIT FUND

- A REIT structure may be used for real estate loan funds. A REIT is classified as a corporation for U.S. tax purposes, and therefore any loan origination activities undertaken by the REIT are not attributed to foreign investors. Foreign investors generally invest in the REIT through an aggregation vehicle such as a Delaware limited partnership.
- A corporation that elects to be taxed as a REIT is allowed a tax deduction for dividends paid to its shareholders, and thus avoids double taxation, provided that certain requirements are satisfied, such as:
  - **Distribution**. The REIT must distribute at least 90 percent of its net income exclusive of capital gains to its shareholders.
  - **Ownership**. The REIT must have 100 or more owners (although this requirement may be satisfied by issuing preferred stock to accommodation owners), and no five or fewer individuals may own directly or indirectly more than 50 percent of the total value of the REIT stock.
  - **Assets**. At least 75 percent of the total value of the REIT's assets must consist of cash, real estate, loans secured by real estate, or U.S. government securities.
  - **Income**. At least 95 percent and 75 percent of the REIT's gross income must be composed of passive-type income and real estate income, respectively.
    - Note that a REIT may also own up to 100 percent of the stock of a corporate entity (a taxable REIT subsidiary) through which the REIT may conduct activities and earn income that may be non-qualifying for REIT purposes.

REIT FUNDS (CONT'D)

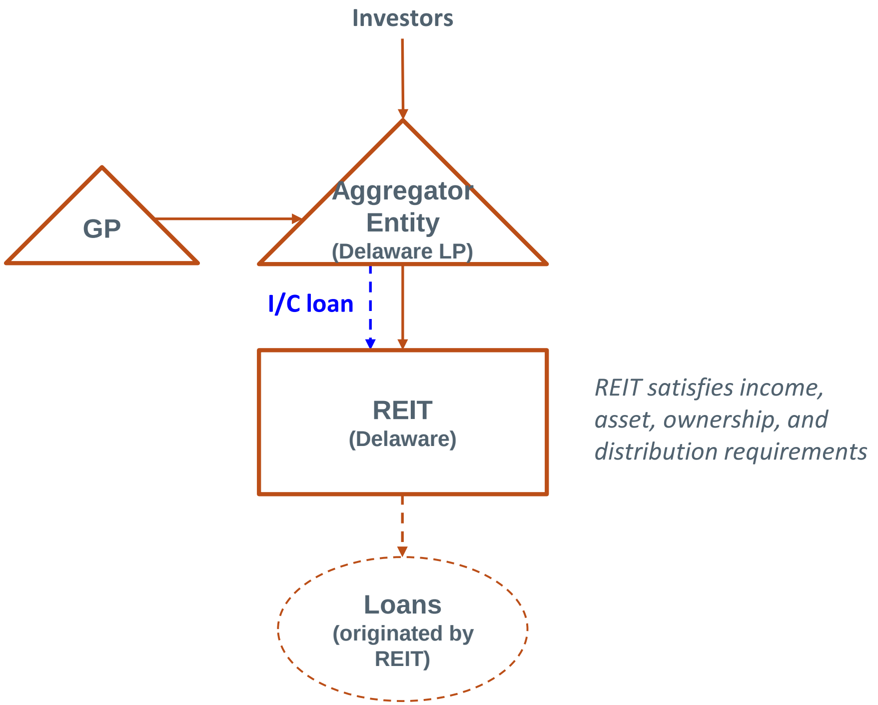
- REITS are often capitalized with both equity and debt, and therefore a foreign investor may receive its return on investment from the REIT in the form of both distributions and interest payments.
  - Interest payments are not subject to U.S. withholding tax if received by a foreign investor that owns, directly or indirectly, less than 10 percent (by vote) of the REIT, and otherwise are generally subject to a withholding at a rate of 30 percent (unless reduced by treaty).
  - The taxation of distributions from a REIT generally depends on whether the distribution is attributable to the REIT's ordinary operating profits or to gain from sales or exchanges of assets (assets that may be held by a REIT include interests in real property located in the United States, as well as loans that participate or share in the appreciation in value of a U.S. real property interest (USRPI).
    - <u>Distributions attributable to a REIT's operating profits</u>: generally subject to a 30 percent U.S. withholding tax applicable to corporate dividends when paid to foreign investors, unless reduced by a treaty.
    - <u>Distributions attributable to the REIT's disposition of assets</u>: generally treated as ECI to a foreign investor if attributable to the sale of USRPI, requiring the investor to report the gain on a U.S. tax return. Foreign corporate investors will generally be subject to branch profits tax of 30 percent on such distributions, subject to treaty reduction.
- Foreign investors (other than qualified foreign pension plans and in certain cases sovereign wealth funds) will generally recognize gain on the sale of shares in a REIT, which gain will be treated as ECI, unless one of the following conditions is satisfied:
  - The REIT is domestically controlled, i.e., less than 50 percent of the REIT stock was owned by foreign investors during the five-year period ending on the disposition.
  - The fair market value of the USRPIs held by the REIT during the five-year period ending on the disposition were less than 50 percent of the sum of the fair market values of the REITs USRPIs, interests in real estate located outside the United States, and other business assets (e.g., loans backed by real estate).
  - The REIT is considered to be "publicly traded" and the foreign investor owns or owned a 10 percent or less interest.

ILLUSTRATIVE EXAMPLE: REIT FUNDS

1) REIT is classified as a corporation for U.S. tax purposes, so loan origination activity is not attributed to Investors.

2) In order to qualify for taxation as a REIT, REIT must satisfy applicable requirements (including income, asset, ownership and distribution tests).

3) REIT is capitalized with equity and debt. Interest may qualify for portfolio interest exemption, dividends from operating income generally subject to 30 percent withholding tax, subject to reduction under an applicable income tax treaty.



Insurance Dedicated Funds (IDFs)

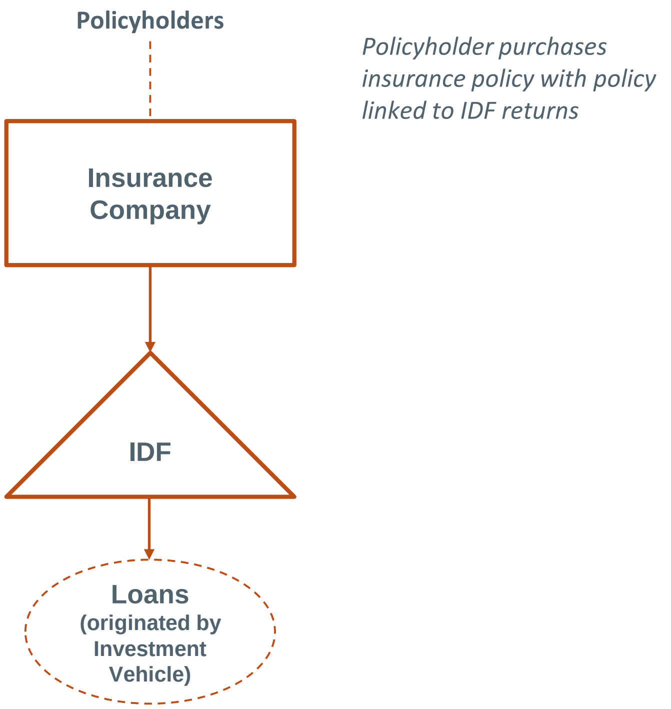
INSURANCE DEDICATED FUND

- An insurance dedicated fund (an IDF) is an investment fund with interests that non-insurance company investors can only invest in indirectly, through the purchase of an insurance policy or annuity contract.
    - A policyholder buys an insurance policy or annuity issued by an insurance company and elects particular investment options.
    - The insurance company then places part of the premium paid by the policyholder in a segregated account, which it invests in an IDF corresponding to the particular option.
    - The policyholder receives a return, through the insurance policy or the annuity, based on the returns of the IDF.
- The policyholder is taxed as the owner of the policy or annuity, and not as the beneficial owner of the underlying assets. Therefore:
    - The investment portfolio of the IDF grows on a tax deferred basis.
    - Tax is deferred until payment is made under the policy.
    - An investor will not recognize any ECI from the IDF's loan origination activities.
- To avoid having policyholders being treated as owners of an IDF's assets for tax purposes, the IDF has to comply with certain diversification requirements, and must avoid running afoul of the "Investor Control Doctrine".
    - **Investor Control Doctrine**. A policyholder will be treated as the owner of the assets supporting the IDF where the policyholder holds enough incidents of control of the IDF (such as the ability to exercise control over the purchase or sale of underlying assets). If a policyholder is considered the owner of the IDF's assets, then such policyholder would generally be presently taxed on the income and gains from such assets (including ECI).
    - **Diversification.** The IDF's portfolio is subject to various diversification requirements, which are generally satisfied if:
        A. No more than 55 percent of the value of the total assets of the account is represented by any one investment;
        B. No more than 70 percent of the value of the total assets of the account is represented by any two investments;
        C. No more than 80 percent of the value of the total assets of the account is represented by any three investments; and
        D. No more than 90 percent of the value of the total assets of the account is represented by any four investments.

ILLUSTRATIVE EXAMPLE: INSURANCE DEDICATED FUND

1) Insurance Company (not Policyholder) is treated as beneficially owning the membership interests in the IDF for tax purposes, so loan origination activity is not attributed to Policyholder, and Policyholder has no current income from the loans.

2) IDF must comply with diversification and "investor control" requirements.



CONTACTS

Sasha Burstein

Partner | San Francisco

+1.415.882.8032

sasha.burstein@klgates.com

Michael W. McGrath

Partner | Boston

+1.617.951.9123

michael.mcgrath@klgates.com

Edward Dartley

Partner | New York

+1.212.536.4874

ed.dartley@klgates.com

Adam J. Tejeda

Partner | New York

+1.212.536.4888

adam.tejeda@klgates.com

Yasho Lahiri

Partner | New York

+1.212.536.4070

yasho.lahiri@klgates.com

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