CADWALADER

Fund Finance Friday

Funds with Benefits? Moving to a Balanced Lender Assignment Approach for Irish 110 Companies

May 31, 2019 | Issue No. 31

By **Kurt Oosterhouse**
Partner | Fund Finance

Lenders typically have a right to assign loans to existing lenders, affiliates or approved funds of existing lenders and, subject to borrower consent, other "eligible assignees."

The consent right of a borrower over other "eligible assignees" normally exists so long as no event of default has occurred and is continuing. While in some cases, borrowers have been successful negotiating limited qualifications on the "sacred right" of lender free assignability, such as (i) maintaining an approval right outside of only "specified events of default" (*i.e.*, payment, bankruptcy, insolvency, etc.) and (ii) qualifying "eligible assignees" as specifically excluding enumerated "disqualified institutions," those qualifications and restrictions eventually fall away at some point in a downturn of a credit and lack of compliance with the credit agreement. Stated differently, a lender's "sacred right" of free assignability may be qualified, but its ability to assign a troubled credit to *any* eligible assignee remains a question of "when" and not "if," since at some point in a borrower's downward spiral (following any event of default, or following only a payment default, bankruptcy, insolvency, etc.), a lender will be able to assign all or a portion of a loan to *any* willing eligible assignee.

That "sacred right," however, may no longer be sacred if you are loaning money into an Irish 110 Company (an "Irish 110") structure.

In a nutshell, an Irish 110 is an Irish resident special purpose vehicle (SPV) which holds and/or manages "qualifying assets." Among its various benefits is the ability to qualify under Ireland's double tax treaty network which can reduce or eliminate taxes on income flows and capital gains in treaty jurisdictions (such as the United States).

As a general U.S. tax matter, the IRS takes the view that funds that originate loans through U.S. managers are engaged in a trade or business in the United States and, as a result, are potentially subject to U.S. federal income tax on income that is "effectively connected" with that U.S. trade or business. However, with respect to an Irish 110 fund, a U.S. manager can originate U.S. loans on behalf of an Irish 110 fund without the fund or its investors being subject to U.S. income tax – so long as the Irish 110 fund qualifies for benefits under the U.S.-Ireland income tax treaty and does not have a "permanent establishment" in the United States.

Very generally, a fund can qualify for benefits under the U.S.-Ireland income tax treaty and avoid a U.S. "permanent establishment" if: (1) it satisfies certain ownership requirements, (2) the amount of deductible expenses that it pays each year to "non-qualified persons" does not exceed 50% of its prior year's gross income, and (3) its U.S. manager is an "independent agent."

For an Irish 110 to satisfy the ownership requirements and the cap on deductible expenses (the "Base Erosion Test") the focus is on the status of "qualified persons" and "non-qualified persons" receiving benefits from the Irish 110. "Qualified Persons" generally include: (1) U.S. individuals, (2) U.S. corporations (including a U.S. tax-exempt entity), (3) a U.S. branch of a foreign bank, or (4) a limited partnership each of whose partners are U.S. individuals or U.S. corporations.

With respect to the Base Erosion Test, deductible payments (including interest payments under profit participating notes and other loans – *i.e.*, subscription facilities) to "non-qualified persons" in any year cannot exceed 50% of the

Irish 110's gross income from the immediately preceding year.

Since the Base Erosion Test picks up interest payments on subscription facilities, Irish 110's have taken the position that subscription facility lenders cannot assign loans to any non-qualified persons under any circumstance. This, they state, is in order to protect the Irish 110 from becoming subject to U.S. federal income tax as a result of deductible payments to "non-qualified persons" in any year to exceeding 50% of the Irish 100's gross income from the immediately preceding year.

"It's a tax issue." Whether one has practiced two years or twenty years, it's impossible to not have run into "it's a tax issue" as the trump card to explain an apparently unexplainable issue or result. Thereupon, the parties seemingly give a nod to the incomprehensible, stop any further analysis and essentially concede that there is nothing further that can be done, since "it's a tax issue."

With respect to the position of Irish 110's that loans cannot be assigned to non-qualified persons under any circumstance –whether or not a payment default, bankruptcy, insolvency, or acceleration shall have occurred – because "it's a "tax issue" seems to be a position taken more as a matter of convenience than actual necessity. This is especially the case when viewed in the context of a lender's right to exit a troubled credit versus the impact of that exit on a borrower who is in the midst of one or more material events of default under its credit facility.

The point isn't to say that an Irish 110 borrower shouldn't have any consent right if no event of default (or even if no specified event of default) shall have occurred, or that a fear of violating the Base Erosion Test wouldn't be an argument for an Irish 110 not consenting to a potential loan assignment to a "non-qualified person." Instead, the point is finding that place on the allocation-of-risk spectrum where the concerns of a lender in maintaining its sacred right of free assignability outweigh the "tax issue" concerns of an Irish 110.

As noted above, with respect to the Base Erosion Test, the test isn't failed if any deductible payments are paid to "non-qualified persons" – only if they exceed 50% of the Irish 110's gross income during its immediately preceding fiscal year. Thus, there are countervailing measures that an Irish 110 can take to manage the 50% limitation on deductible payments to non-qualified persons in order to stay within the rule – such as repaying the loan and/or restructuring its ownership of or payments on profit-participating notes. Would it be administratively difficult to manage the 50% test via tracking the commitment percentage and interest payments to non-qualified persons and/or to restructure ownership and payments under profit-participating notes? Certainly.

However, it seems difficult to argue that at some point (and certainly to the extent a "specified event of default" shall have occurred, and thus the Irish 110 is subject to a payment event of default, an accelerated loan or even a bankruptcy event), the sacred right of a lender to sell its loan to any willing eligible assignee outweighs the "tax issue" concerns of an Irish 110 – no matter how adverse the repercussions may be to its investors.