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Using Irish Treaty Funds To Avoid US Taxes In Direct Lending

By **Jason Schwartz and Gregg Jubin** (September 30, 2019, 11:51 AM EDT)

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Private debt funds raised more than $100 billion for the fourth consecutive year in 2018,[1] and reached their highest level of fundraising on record during the first half of 2019.[2]

However, U.S. tax law potentially hinders U.S. managers from sponsoring direct lending funds that have foreign investors: The IRS has asserted that foreign funds managed from within the U.S. and make loans directly to borrowers may be engaged in a U.S. trade or business and subject to U.S. tax.

One way a U.S. manager can engage in primary loan origination on behalf of a foreign fund and still avoid subjecting the fund to U.S. taxes is to organize the fund in Ireland and ensure the fund (1) qualifies for benefits under the U.S.-Ireland income tax treaty, and (2) does not have a U.S. permanent establishment.[3] Structuring this Irish treaty fund is not without challenges. However, for some managers and investors, the rewards justify the effort.

General Structure

Irish treaty funds typically are organized either as Section 110 companies or as Irish collective asset management vehicles, or ICAVs.

A Section 110 company is an Irish entity that can issue profit-participating notes that provide for interest equal to substantially all of the company's net profits before interest. The interest on the profit-participating notes is deductible for Irish tax purposes, and can be paid in a manner that eliminates Irish withholding tax. Accordingly, by issuing profit-participating notes, a Section 110 company can reduce its net income to a nominal amount and eliminate virtually all Irish corporate tax liability.

An ICAV is a collective investment vehicle that is statutorily exempt from Irish tax on profits. ICAVs are subject to significantly more regulation — and therefore tend to be more expensive to set up and maintain — than Section 110 companies.

Qualifying for Benefits Under the Irish Treaty

To qualify for benefits under the treaty, an Irish resident, such as a Section 110 company or an ICAV, must satisfy the treaty's limitation on benefits article.

The limitation on benefits article is intended to prevent those that are not intended beneficiaries of the treaty from using the treaty to reduce their aggregate tax liability. The limitation on benefits article lists several categories of intended beneficiaries. The category most commonly used by Irish treaty funds (because it allows for the most diverse investor base) requires the fund to satisfy two tests: an ownership test and a base erosion test.

Ownership Test

Under the ownership test, at least 50% of the aggregate vote and value of the Irish treaty fund's shares generally must be directly or indirectly owned by U.S. residents and certain other "good persons."[4]

For this purpose, a Section 110 company's profit participating notes likely are treated as its shares.

Because the ownership test is a "direct or indirect" test, an Irish treaty fund generally should satisfy the test if more than 50% of its shares are ultimately owned by U.S. residents, even if those U.S. residents own the shares through feeder funds or other entities that are not, themselves, "good persons."

Base Erosion Test

Under the base erosion test, amounts the Irish treaty fund pays or accrues to those other than U.S. residents and other "good persons" and that are deductible for Irish tax purposes generally may not exceed 50% of the fund's gross income.

As mentioned above, ICAVs are not subject to entity-level tax on profits in Ireland. Accordingly, ICAVs do not make any payments that are treated as deductible for Irish tax purposes, and do not have to worry about satisfying the base erosion test.

By contrast, Section 110 companies must make deductible payments to minimize their Irish corporate tax liability. The most significant deductible payments that an Irish treaty fund will make if it is organized as a Section 110 company will be (1) interest payments on its profit participating notes, (2) interest payments on any other leverage it incurs, and (3) fees it pays to its investment manager.

The base erosion test does not count arm's-length payments in the ordinary course of business on a financial obligation to a bank, as long as the bank is a U.S. or Irish resident or the payments are made to a bank's U.S. or Irish permanent establishment. Accordingly, Irish treaty funds that are organized as Section 110 companies often sign credit facilities only with U.S. or Irish banks or their branches, and negotiate for provisions that limit or restrict the bank's ability to assign or participate the loan to bad persons.[5]

The base erosion test also does not count arm's-length service payments. Management fees should fall within this exclusion.

The treaty defines "gross income" to mean the greater of (x) a fund's gross income in the preceding fiscal year and (y) the average of its gross income in the preceding four fiscal years. It is not entirely clear whether this look-back definition of gross income is mandatory or optional. If the definition is mandatory, then it can create serious issues if a fund's income in one year exceeds its income in one or more earlier years.

Suppose, for example, a fund earns $100 of gross income in year 1, and $103 of gross income in year 2, and that in each year its only deductible payments are interest payments on its profit-participating notes. If the fund's profit-participating notes are held 49% by bad persons, then, using the look-back definition of gross income, the fund will fail the base erosion test in year 2 because it has made deductible payments of $50.47 to bad persons (i.e., 49% of $103 gross income), which exceeds 50% of its year 1 gross income.

To mitigate this potential problem, some funds structure their profit-participating notes so the fund is not entitled to a deduction on the notes to the extent the deduction would cause the fund to fail the base erosion test.

Avoiding a U.S. Permanent Establishment

A fund that qualifies for benefits under the Irish treaty is subject to U.S. tax only on profits that are attributable to a U.S. permanent establishment.

Irish treaty funds do not have physical offices in the U.S. However, under the treaty, a fund manager's U.S. office can be attributed to the fund unless the manager is an independent agent acting in the ordinary course of its business.

The Irish treaty does not define the term "independent agent." However, IRS guidance and a Tax Court decision provide that an agent is an independent agent if it is both legally and economically independent of its principal.

Legal Independence

An agent generally is legally independent from its principal if the agent is free in the manner by which it performs its duties for the principal.

U.S. investment managers typically are legally independent under this definition, because they are free to engage in their investment management activities as they see fit, subject only to broad parameters established under their investment management agreement with the Irish treaty fund, and also may terminate their investment management agreement.

Some tax practitioners have expressed concern that a manager of an Irish treaty fund cannot be an independent agent because the manager, as sponsor of the fund, effectively hires itself, which is uncharacteristic of separate business enterprises.

One rebuttal to this concern is that the fund's execution of a management agreement represents a consensus among the fund's ultimate investors to entrust the manager as the fund's agent. Additionally, the manager's success at convincing investors to contribute capital to the fund merely underscores the distinction between the manager's business of making and managing investments on behalf of customers, on one hand, and the fund's business of making proprietary investments through the manager, on the other.[6]

Economic Independence

An agent generally is economically independent from its principal if the agent bears its own entrepreneurial risk, in that it is not guaranteed revenue and is not protected from loss if it is unable to generate sufficient revenue.

Tax practitioners tend to focus on four factors when assessing whether a U.S. manager is economically independent of an Irish treaty fund:

1. Multiplicity of clients: A common rule of thumb is that the manager should have at least 10 clients, including the Irish treaty fund, for which it performs services requiring the same skill set. Although there is a range of views on the matter, each of the manager's ultimate investors arguably should be counted as a separate client for this purpose, since these ultimate investors are the manager's true customers.

2. Breadth of business: To ensure that a manager is not substantially dependent on an Irish treaty fund, many tax practitioners require that the manager's total projected compensation from the fund not exceed 10%-15% of its total compensation from its other clients.

3. Growth potential: Tax practitioners typically require managers of Irish treaty funds to represent that (1) they have the requisite expertise to engage in the activities with respect to which they intend to claim independent agent status, (2) any additional hires would be to help manage their overall workload, and not because the existing personnel lack some skill essential to performing those activities, and (3) they have the capability and opportunity to obtain new clients with minimal modifications to their current business and with minimal or no adverse impact on their current business profits.

4. Arm's-length fees: Most tax practitioners require treaty fund managers to represent that they will receive an arm's-length fee for their services, that the formula for computing the compensation will not be dependent upon the manager's own overhead expenses, and that the manager will be responsible for its own overhead expenses, and thus will bear losses if its overhead expenses exceed its compensation.

Conclusion

Given the emergence of direct lending as a popular asset class for institutional investors, an Irish treaty fund could be a powerful tool for U.S. managers with access to foreign capital, whose deployment might otherwise be waylaid by U.S. tax concerns.

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[1] See Hannah George & Kelsey Butler, Who Needs a Bank? Why Direct Lending Is Surging, Bloomberg (Mar. 6, 2019), available at https://www.bloomberg.com/news/articles/2019-03-06/who-needs-a-bank-why-direct-lending-is-surging-quicktake-q-a. As of June 2018, private debt assets under management reached $769 billion. See Preqin, Press Release, Private Debt Industry Keeps Up Its Momentum (Feb. 21, 2019), available at https://docs.preqin.com/press/GPDR-Launch-2019.pdf.

[2] See Kelsey Butler, Direct Lending Funds Raise Record-Breaking Cash, and Concerns, Bloomberg (July 1, 2019), available at https://www.bloomberg.com/news/articles/2019-07-01/direct-lending-funds-raise-record-breaking-cash-and-concerns.

[3] The United States has income tax treaties with many jurisdictions. However, Ireland is a popular jurisdiction for U.S.-managed direct lending funds because (1) there are a number of sophisticated English-speaking legal services providers in Ireland, and (2) as discussed below, Irish treaty funds can be organized so as not to be subject to tax in Ireland.

[4]"Good persons" include certain persons that are not U.S. residents. However, most U.S.-managed direct lending funds that are organized as Irish treaty funds rely on U.S. residents to satisfy both the ownership and base erosion tests.

[5] If the bank preserves its right to assign or participate the loan to a bad person, then the fund typically would insist on having a right to prepay the loan in the event that the assignment or participation would cause the fund to fail the base erosion test.

[6] Moreover, when an Irish treaty fund is organized as an ICAV, it must be managed by a manager that is regulated in Ireland as an alternative investment fund manager, or AIFM. The AIFM is responsible for providing investment management and risk management services to the ICAV, and has a nontransferable fiduciary duty to the ICAV's shareholders. The AIFM delegates its investment management responsibilities to a U.S. manager, but typically is permitted to fire the U.S. manager for cause. The AIFM's role arguably creates further separation between the enterprises of the ICAV and the U.S. manager.