Credit Funds: A Global Perspective on Evolving Structures

Seminar Key Points

2018

Dechert LLP

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Introduction

Dechert's 'Credit Funds: A Global Perspective on Evolving Structures' seminar, held on 24 January 2018 in London, brought together professionals from our tax and investment management groups to discuss market trends and share fund structuring insights across key jurisdictions.

Following a welcome address by Daniel Dunn, head of Dechert's global tax group based in New York, Christopher Gardner set the scene for the seminar giving an overview of recent trends in the global credit fund sector. Chris referenced some of the key findings from a report on the private credit market which Dechert published in conjunction with the Alternative Credit Council. The report – *Financing the Economy 2017: The Role of Private Credit Managers in Supporting Economic Growth* – can be accessed online here.

Key findings:

- If current AUM credit fund growth rates continue, the sector will reach US$1 trillion in AUM by 2019.
- The U.S. is, by a significant margin, the most developed market for credit funds with Germany, the UK, the U.S. and France offering the greatest opportunities over the next three years.
- Regulatory reforms in Europe and Asia Pacific are supporting growth in the sector, which is now shown as lending across a much broader spectrum of borrowers, industries, ticket sizes and loan structures.

Speakers

Daniel Dunn
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United Kingdom

Overview:

Mark Stapleton, a London based-partner in Dechert's global tax practice gave a brief overview of the current state of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Package, which has introduced a number of measures aimed at unacceptable tax planning strategies by multinational enterprises. While these measures are primarily targeted at multinational enterprises, Mark noted that the BEPS measures also impact credit funds and their investment managers. In particular, Mark outlined Action Point 6 (Treaty Abuse) and Action Point 7 (Permanent Establishment) which is of particular relevance and concern to credit funds and which impacts the viability of existing common structures in the market (such as the use of treaty eligible subsidiary vehicles).

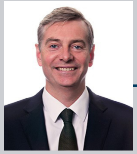
Key points:

- The UK does not currently have a competitive credit fund vehicle which can be marketed widely to non-UK investors due to a mixture of tax and regulatory issues. Brexit would be a good opportunity for the UK Government to introduce a more suitable and competitive vehicle.

- Many funds rely on interposing intermediate subsidiary vehicles in the fund structure in order to minimise tax leakage and obtain withholding tax reliefs. Going forward, the ability of such a subsidiary vehicle to minimise withholding taxes in this manner will be affected by BEPS Action Point 6 (Treaty Abuse).

- Our current understanding is that the UK and European jurisdictions are likely to adopt the "principal purpose test" through the BEPS multilateral instrument (MLI) in their tax treaties. This test asks whether it is reasonable to conclude that obtaining a treaty benefit was the main purpose of the transaction or arrangement and if it was to deny treaty benefits unless it can be shown that the obtaining of such benefits was within the object and purpose of the treaty. The MLI is likely to begin to be adopted in treaties from 2019 and so it is important for private credit fund managers to review existing and potential future fund structures to ensure they are robust in a post BEPS environment. Where possible, the existence of treaty eligible vehicles in a particular jurisdiction should be underpinned with commercial rationale and might be aligned with the jurisdiction of the fund. In addition consideration should be given to enhancing business "substance" in the relevant jurisdiction. The creation of parallel funds for specific investors might also be worthy of consideration.

- BEPS Action Point 7 (Permanent Establishment) expands the scope of what can constitute a taxable permanent establishment to include situations where agents habitually play a lead role in the conclusion of contracts or agreements without material modification by the offshore credit fund. Its impact should be borne in mind when assessing whether agents sourcing and negotiating deals in borrower jurisdictions could create a taxable permanent establishment of the credit fund in that jurisdiction.



Key contact

Mark Stapleton

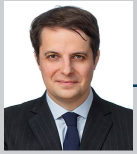
Luxembourg

Overview:

Patrick Goebel and Florent Trouiller, partners in Dechert's Luxembourg office gave a brief overview of the regulatory and tax considerations surrounding loan origination by Luxembourg funds. Luxembourg credit funds are typically regulated funds such as specialized investment funds (SIFs) and non-regulated funds such as reserved alternative investment funds (RAIFs). Loan origination has to be embedded within the defined policy of the fund excluding lending to the public which is an activity separately regulated under the Financial Sector Law. The Luxembourg supervisory authority, *Commission de Surveillance du Secteur Financier* (CSSF), provided in its Q&A on the professionals of the financial sector guidelines on what is not considered as lending to the public and hence permitted for a fund. The CSSF also provided guidelines in its FAQ on the AIFMD on what a Luxembourg AIFM has to comply with when managing credit funds. Downstream structures are typically used in the context of credit funds in Luxembourg. They may encompass for instance the setting-up of intermediate holding companies or securitization vehicles. Substance and commercial rationale will have to be carefully assessed in a post BEPS context.

Key points:

- Luxembourg is a hub in Europe for the domicile of credit funds.
- Various BEPS Action Points have a direct impact on a typical credit fund in Luxembourg and that funds will need to adhere to additional guidelines and think through the impact of BEPS on every aspect of the structure.
- SIFs, RAIFs and other type of Luxembourg AIFs such as common or special limited partnerships may be used for debt acquisition purposes and for loan origination, provided no lending is made to the public.
- SIFs and RAIFs may be structured as joint-stock companies and may be eligible for tax treaty benefits. This has to be analysed on a case by case basis.

Key contacts

Patrick Goebel and Florent Trouiller

Germany

Overview:

Hans Stamm, a partner in Dechert's Munich funds and tax practice briefly set out the tax and regulatory concerns surrounding loan origination in Germany. Before March 2016 the granting of loans to German borrowers, even on a cross-border basis into Germany, required a banking license. However, recent regulatory changes provides an ability for certain types of AIFMD compliant closed ended AIFs to originate loans in Germany. The recent regulatory changes only apply at the AIF level; no clear guidance exists if this also applies to SPVs controlled by the AIF credit fund. From a German tax perspective, although interest on loans paid to a foreign AIF in principle does not trigger German withholding tax, however for certain loans (e.g. secured by German real estate or with profit contingent interest coupon) German withholding tax applies. This may be mitigated under a Tax Treaty with Germany. As such, there are additional complications which would need to be considered in order to navigate the tax and regulatory framework properly.

Hans Stamm also set out a road map to fundraising issues in Germany, and detailed which rules and laws to abide by when targeting institutional investors and the specific tax aspects that certain German investors are concerned with.

Key points:

- Historically the German market was overbanked, but as a consequence of the Financial Crisis and the introduction of Basel III Capital requirements banks have retreated from lending, particularly on long term loans. Further following regulatory changes in 2016, non-banks in the form of EU AIFM/AIF, can now lend without a banking license.
- In a world where German government bonds still have negative yields, German institutional investors are allocating more of their portfolios from corporate bonds into credit funds. There is a significant opportunity for credit funds to fundraise in Germany provided the regulatory and tax requirements of institutional are properly addressed.
- A UK AIFM managing an EU AIF may not be permitted to originate loans in the German market following Brexit.
- In general, there is no German withholding tax on interest (except on interest from loans secured on German real estate and loans with a profit contingency coupon element).

Key contact

Hans Stamm

France

Overview:

Antoine Sarailler, a Paris-based partner in the Financial Services Group and Sabina Comis, a Paris based partner in Dechert's global tax practice explained the recent opportunities for debt funds to be set up in France. Historically the granting of loans in France could only be undertaken by banks, but recent regulatory changes in France in 2016 now means that specific French funds that have recently been introduced can now originate loans directly in France. These French fund vehicles are flexible and are easy to set up and launch.

Available funds include the "fonds professionnels spécialisés" (FPS), which can be established as: (i) a "fonds commun de placement" (FCP) (a contractual common ownership entity without legal personality), or (ii) a Société de Libre Partenariat (SLP) (similar to an English LP), or (iii) a "société d'investissement à capital variable" (SICAV) (constituted as an investment company which is similar to a UK OEIC). In addition, another option is to use the recently established French *Organisme de Financement Specialisé* (OFS) with or without a distinct legal personality.

The OFS has been introduced to act as a flexible alternative, and has the following advantages:

- *The OFS does not require prior authorization by the Autorité des marchés financiers (AMF), the French regulator (the documentation is, however, filed with the AMF).*
- *There are no restrictions on the fund's strategy and no diversification parameters/risk limits apply.*
- *The OFS can issue bonds (which the FPS cannot)*
- *The content of the fund's documentation is not prescribed and can be in English (but must generally be tailored to market practice).*
- *The OFS benefits from some derogatory protection in the event of insolvency proceedings of a borrower.*

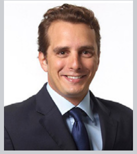
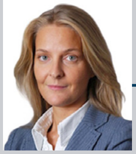
As an AIF, the OFS requires an AIFM. A French AIFM or a foreign AIFM can be used (although the latter must show the AMF that it has the capacity and technical expertise to manage a loan fund as if it were a French AIFM – French substance is not required, as the AIFM may act on the basis of the AIFMD passport). The OFS also requires a French depositary and statutory auditor.

Key points:

- New French funds are lightly regulated and do not need to seek advance approval from the French AMF. In order to launch, the credit fund only needs to comply with the prospectus rules for the information memorandum document.

  There is no French withholding tax on interest payments. In addition, there should be no tax at the level of the French fund entity – these entities are generally treated as tax transparent. Investors in the French fund receive income as and when distributed rather than when income arises in the fund. As such, the French funds have efficient cash repatriation mechanisms

- There is nevertheless a current debate as to whether an SLP can rely on double tax treaties, and whether or not an intermediate holding company can be set up in order to try and mitigate foreign withholding tax issues.

Key contacts

Antoine Sarailler and Sabina Comis

United States

Overview:

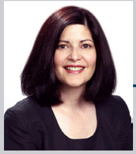
Adrienne Baker, a Boston-based partner in Dechert's global tax practice, briefly outlined the key U.S. tax considerations for various categories of fund investors. There is significant demand in the U.S. for setting up credit funds notwithstanding the sometimes difficult tax issues which arise.

Key points:

- The common structures U.S. based credit funds can take, from the least complex (and least tax efficient) structures to the more complicated (but more tax efficient) structures. One of the more tax efficient options with no tax drag (a U.S. fund set up as a Corporate "RIC" Structure) avoids entity level tax and adverse tax consequences for investors as well as withholding taxes on U.S. source interest and capital gains. However, whilst there is significant tax upside to a RIC structure, the downside is the significant regulatory and compliance obligations and costs that need to be satisfied in order to operate the structure.

- Another common structure in the U.S. for a credit fund designed to allow non-U.S. investors the benefit of U.S. statutory trading safe harbors (to shield non-U.S. investors from U.S. net income taxation) applicable to secondary market debt investments but not loan origination is the "season and sell" structure. However, this structure needs to closely adhere to certain guidelines to reduce the possibility that U.S. loan origination activity will be attributed to non-U.S. investors.

- U.S. tax treaties may, subject to satisfying certain anti-treaty shopping and other conditions, provide a U.S. federal income tax solution for treaty eligible investors although may not eliminate U.S. state and local taxation.



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Dechert's Global Tax Practice

Tax issues underlie virtually every business formation, plan and transaction – whether domestic, international or cross-border. Tax laws and regulations are more than just considerations; they often drive business strategy, structure and deal consummation.

The firm provides inventive tax solutions that meet the challenges and objectives of clients' most sophisticated business dealings around the globe, from corporate transactions and restructurings, to financial transactions and fund formation and investing.

Dechert is "jurisdiction neutral" when it comes to structuring credit funds (in that the firm doesn't market one product and one jurisdiction for credit funds to be set up), and instead aims to utilise its global network of international offices and associated expertise to set up structures that best addresses the specific regulatory and tax issues which inform credit fund structures bearing in mind the investment opportunities, and investor preferences.

Tax counsel for the world's most complex transactions

Investment management

Our tax team advises on the complex tax issues facing U.S. and foreign investment companies, advisers, managers and distributors. We innovate so clients can meet the marketplace's demands. For example, we obtained rulings that allow wholly-owned fund subsidiaries to invest in commodities; that qualified a venture capital fund as a regulated investment company (RIC); and structured fees paid by funds and their advisers to avoid preferential dividend concerns. We advise on tax issues pertaining to all types of U.S. and non-U.S. funds (e.g., fund of funds, master-feeder, hedge, offshore, venture capital, exchange-traded and commodity), fund mergers and reorganisations, diversification requirements and dozens of other related issues.

Private equity finds

A key niche area for the firm is permanent capital, which is a growing development in the private equity industry. Our tax lawyers advise on the tax consequences of various permanent capital vehicles, including business development companies (BDCs), master limited partnerships (MLPs), real estate investment trusts (REITs) and closed-end funds. Another key area for our tax lawyers is middle market private equity. Our tax lawyers, working alongside Dechert's top-ranked private equity team, advise middle market private equity firms on holding company structures, exit and financing strategies, management fees and other tax planning issues.

World Compass

Dechert has developed a web-based subscription service that offers investment firms 24/7 access to concise global marketing and distribution guidance in approximately 100 jurisdictions worldwide as well as beneficial ownership reporting requirements. World Compass has recently been extended to include banking licensing requirements at a jurisdictional level.

Thank You

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