Tax in asset management: Private credit and CLOs

Transcript

SPEAKERS:

Eric Coombs, Asset Management Tax Services Leader, Grant Thornton Advisors LLC

Satish Katikala, Senior Manager, Partnership Tax Solutions, Grant Thornton Advisors LLC

ERIC COOMBS: Welcome to the Grant Thornton podcast, where we share information about the latest trends and business issues of the day.
I'm Eric Coombs, Tax Services Leader for Grant Thornton's asset management practice. As part of our series on key tax issues in the asset management industry, I'm speaking with Satish Katikala, Senior Manager in our tax practice focused on private credit and CLOs.
So, Satish, thanks for spending some time with us today to chat about this topic.

SATISH KATIKALA: Thank you, Eric.

Happy to be here.

ERIC COOMBS: Fantastic.

So maybe, just from a macro level, you could explain to the audience why private credit funds have become so popular in the last year or two.

SATISH KATIKALA: Yeah, definitely.

Private credit has become a very attractive asset class given the strict constraints on the banking side. Essentially, this private credit includes various categories such as real estate debt, venture capital loans and leveraged loans, and the important thing is this private credit continues to deliver higher returns with a lower volatility compared to regular leveraged bank loans and high-yield bonds.

So definitely, it is an attractive asset class for various investors.

ERIC COOMBS: Fantastic.

And what do you see as some of the key tax challenges that private credit's facing currently?

SATISH KATIKALA: There are several tax challenges that can affect the after-tax returns for the investors, depending on some factors such as the type of credit,

whether it is a senior match, or subordinated, and also the underlying collateral is it real estate loans, consumer loans, corporate loans.

So essentially, it is required to make sure an optimal tax structuring is in place for every private credit fund that we structure.

ERIC COOMBS: Certainly.

And as we get into thinking about tax planning strategies, maybe you can dive into some of the structuring considerations that we think about, whether we're forming a new fund or perhaps kicking the tires on current structure of an already operating fund.

SATISH KATIKALA: Yeah, absolutely.

The tax challenge that comes especially in the private credit is the tax withholding on interest — complex tax reporting like PFIC reporting or 5471 if the holder is a foreign corporation, so there can be debt-to-equity issues that we see generally associated with the restructuring because it has got its own administrative challenges to move the equity into the appropriate legal structure, especially the equities such as the corp interest, the partnership interest or REO property in particular, to make sure the tax implications for the investors are properly handled and tracking the tax documents to report the taxable income appropriately.

Some of the tax strategies in private credit depend on again the investment strategies implemented by the managers such as is it a direct lending versus secondary, or the type of debt and the investor type within the structure.

So generally there is no withholding required on interest if it meets the portfolio interest exemption, that's what we generally see. However, one of the requirements for the portfolio interest exemption is that the debt should be in registered form. Most of the debt, like corporate debt, is in registered form, but some types of debt such as consumer loans and mortgage loans are not in registered forms. So careful tax planning is required to minimize and avoid the tax withholding for these types of loans. For example, using a grantor trust as a wrapper entity to have the portfolio interest exemption applicable.

The primary goal in private credit that we see with regards to the foreign investors is avoiding effectively connected income, as you know, most of the foreign investors are caring about.

Essentially, the effectively connected income we see in private credit is from loan origination activities, which is considered a trade or business for U.S. income tax purposes.

The effectively connected income requires foreign investors to file the federal tax return and pay a 21% tax rate if it is a foreign corporation or up to 37% if it is a foreign individual. In addition to the effectively connected income tax, there can be a 30% branch profits tax or reduced treaty rates as applicable.

So that's about the foreign investors. When it comes to the tax-exempt investors again, the UBTI is one of the key areas the tax-exempt investors are worried about. Generally, the lending business does not generate the UBTI for the tax exempts. However, if there is leverage in the business, there can be unrelated debt finance income that is taxable to the tax exempts.

Some of the common strategies in private credit that we see are season and sell, leveraged blocker, and tax treaty structures. Again, depending on the business objective, one of these strategies can be implemented. Again, I'm not going to discuss in detail about each strategy, but depending on the business need, we can implement one of these strategies.

Last but not the least, of the taxable investors, right, the interest income for the taxable investors is taxed at the ordinary rates, and they generally prefer to come through the flow-through vehicle just to avoid the two layers of tax.

ERIC COOMBS: Yep. Fantastic. And that all makes sense, Satish, and listening to your comments, it's evident how important it is, not only to make sure that we get the structuring right up front for these types of funds but also how important it is that funds are working with advisers that understand U.S. federal implications but also the international implications.

Perhaps you can talk a little bit more about how and why it's important to have a well-rounded tax team that can address the tax needs at both the U.S. federal and foreign levels?

SATISH KATIKALA: Yeah, absolutely.

Because again, this private credit market is booming in recent years, it's really important to have appropriate tax planning done at the outset when structuring the new funds to make sure the entities are structured properly to avoid any unintended

tax results for the investors, so it is very required to have the tax adviser's opinion in place at the beginning of structuring these credit funds.

ERIC COOMBS: Yep. And I know from experience this is an area where you can quickly run into some trouble if there's any misreporting, certainly all the penalties and risk from not filing the adequate withholding forms for foreign investors can be quite steep from a U.S. tax perspective.

SATISH KATIKALA: Absolutely. Just to add with regard to that, like the withholding taxes, I have seen some scenarios where the withholding agent did not withhold on time and they made the distribution to the investors. Once the distribution is done, it's really hard to get the money back to get the withholding done.

So it's very, very important to have the proper documentation in place, timely to the withholding, especially before the distribution, so that everybody is on the same page.

ERIC COOMBS: Satish, I know you do a great deal of work in the CLO space as well. Can you talk about how some of the challenges with CLOs might differ from traditional private credit funds?

SATISH KATIKALA: Absolutely. So a couple of things unique to the CLO is again most of the CLOs are formed in foreign jurisdictions, especially in the Cayman Islands. Those are the foreign corporations and they hold the debt across various sectors, pretty much they touch every sector to have diversified sectors that they are covering.

One of the compliance needs is to make sure there is no ECI income flowing up to the CLO. Since it is a foreign corporation that could be potential tax leakage for those entities.

The problem happens on the CLO side when there is a debt-to-equity restructuring by the borrowers. When the equity is issued to the CLO, they need to make sure what type of equity is that.

Is that the equity of a corp or whether it is a partnership interest or whether it is a REO property. We don't see the REO property generally in CLO side but a lot of times we see the partnership interest that has the potential to flow the ECI up in the chain to the CLO.

To avoid this, generally, the CLOs will come with their own tax subsidiary, which is a de-levered corporation. Once the trading is done, they need to make sure the partnership interest is properly moved into the subsidiary, the tax blocker, so that the ECI is not flowing into the foreign corporation.

In addition to that, they need to properly make sure the K-1s and the K-3s are requested from the partnerships on time, properly tracking how many partnership interests the blocker has and discussing with the tax adviser to make sure the tax reporting is properly done for those blockers.

ERIC COOMBS: That makes sense, and certainly from my perspective I am familiar with the challenges of ensuring that K-1s are received with enough time to properly address any matters that are reported on them.

So Satish, I want to thank you today for your time.

I appreciate you sharing your insights. For those that would like to learn more, I would ask you to please just log into gt.com for additional information.

Thanks for tuning in.

SATISH KATIKALA: Thank you, Eric.