Talking Asset Management with KPMG

Credit Funds: Trends in structuring and audit activity

The following is a transcript of Talking Asset Management with KPMG. In this episode **Patrick Brooks**, a tax partner in the KPMG BTS Asset Management practice, and **Sam Riesenberg**, a principal with the KPMG International Tax practice, discuss credit fund trends, structuring, and audit activity.

Transcript:

Patrick Brooks:

Welcome back everyone. This is Pat Brooks and this is our Talking Asset Management with KPMG. The last call, we spent talking about the YA Global case and what it was and why people should really be thinking about it. Today, Sam and I are going to talk a little bit more about the impact YA Global has on structuring, but also what other structuring and trends we're seeing and also audit activity. So Sam, maybe we can just start out talking about, what have people been doing as a result of this YA Global case?

Sam Riesenberg:

So the answer is probably not too much just yet. People are nervous, if you will, about the case, but probably more nervous about the audit activity that's going on right now and has been announced by the IRS as well. I think we're going to touch on that in a minute. So if I had to pinpoint what is motivating the credit fund community at large regarding federal tax, it's probably a little bit less this case to date and more probably some of the concerns around the audit issues.

Patrick Brooks:

Actually, now you just changed my agenda around a little bit since you already mentioned the IRS audit activity. What did the IRS announce? Because this is something that, at least with my clients are like, "Wow, wait a minute. What's the IRS going to be doing?" So maybe you could just summarize a little bit about what the IRS is considering or what their thoughts are.

Sam Riesenberg:

Sure. We knew for some time that the IRS was looking at potentially launching a campaign around loan origination, trying to determine what exactly is going on in the area. And they actually did announce it with very little fanfare within the actual announcement, but it showed up on the IRS website, it showed up in the tax press saying that they were looking into some issues around the trading safe harbor. And they clarified in some of their public speaking that they are interested in what's going on in the area of loan origination. They called it a "underserved area" for their audit activities and wanted to see if there's particular issues that they should be focusing in on.

What we've seen to date, it's unclear whether that's actually part of the campaign or not. But we have seen an uptick in activity where agents are asking about loan origination and funds. How it's being done? What are the parameters being followed in doing loan origination where it could give rise to a potential US taxation of non-US persons? That hasn't really progressed too much beyond the initial questioning stage. And we expect those questions to be revised further and refined as they're trying to get their heads around what the industry has done.

Patrick Brooks:

Yeah. What I was speaking to clients about, what I have been speaking to clients about, is actually their guidelines and we'll get in to some of the structures. But this seems to be when people do season and sell structures in particular, they have some guidelines. And the IRS, I believe, is really trying to figure out, "Okay, what are those guidelines and are people adhering to those guidelines?"

Sam Riesenberg:

So that's certainly been the rumor and conjecture that we've heard around this particular campaign. The IRS wanted to get access to the guidelines, wanted to see whether those guidelines are being followed. And as you say, particularly within the so-called horizontal or affiliate season and sell space, which as you say, Pat, is something that we normally would see associated with guidelines that are produced by their US tax advisors. So far, we haven't seen that the questions and the focus, and when asked, the IRS has indicated to us they didn't really believe that that was the focus at least today.

Patrick Brooks:

Got it. So when we talk about the IRS audit activity and we hear about this thing going on with credit funds, but there's also two other spots that sort of impact funds. The first seems to be the increased activity to partners that IRS has on partnerships in general. And the second one is the just foreign corporations themselves, right? I mean, we're dealing with three different targets that can impact funds.

Sam Riesenberg:

I'd add one to that as maybe as a subset. So we have certainly the BBA with increased partnership audit activity and the IRS saying that they're going to start looking more at, and we have seen increased audit activity with partnerships. Then we have, coming up, the new K2/K3 initiative which basically breaks out all of your international stuff that you used to throw into footnotes on a K1 that was being reported out to investors. And there was no real way for the IRS to dig down perhaps with a computer or an algorithm to figure out what was weird or what was being reported unusually that would warrant pulling a return for audit. These are all being broken out now from an international perspective.

And then as you say, in addition, there is an increased interest in auditing foreign corporations just more generally determining what exactly is going on from an inbound perspective. We haven't seen that in the last dozen years or so as IRS resources have been constrained. Now that we're seeing a little bit more budget for the IRS, we're seeing a focus by the IRS on some of these inbound activities as well, we certainly expect from all of those sides to come together and potentially put more of an eye on what's going on in the loan origination space.

Patrick Brooks:

You had to drop the K2/K3 in this conversation. We are not going to go down that path. That could be another two podcasts outside of this. So we're not going to go down that rabbit hole right now. So Sam, the audit activity, a lot going on. From a structured perspective though and trends and structuring, what are some of the things that you're seeing from a structuring standpoint, what are people starting to do? Is there anything new or something that people should be aware of?

Sam Riesenberg:

Yeah. We're seeing a trend that that was pretty hot in the last couple years since tax reform reversing itself out, and that was the trend to use more leverage blockers. And certainly when corporate tax rates went down in 2017 to 21% from 35% at the federal level, there was a lot of interest in the ability to use a blocker and your leakage was rather low. And it was a pretty safe way to do things. And so a lot of people looked at doing that, but as more and more money is piled in to certainly foreign capital, that there's certainly a race between the different credit funds to determine the most effective way and the most tax efficient way to deploy that capital in the US.

And oftentimes, a leverage blocker is not that entity. And in addition, when you're in a leverage blocker, you have risk of the rates rising and not necessarily being the best way to do it. So we certainly see people still doing season and sell structures. A lot of that are in fact enhancing those season and sell structures. We're seeing still a lot of investors coming in through treaty investments claiming that they do not have a permanent establishment from their activities of including loan origination into the United States. That is certainly becoming an increasingly large portion of the market. And again, there's still a lot of people that are doing their activities or making sure that their activities conform with a more de minimis approach. That maybe they're not doing loan origination to start and prescribing their activities in a way that they're not originating loans. They may be acquiring them or not doing a large amount of loan origination within some guidance.

Patrick Brooks:

It's interesting when you talk about the de minimis or season and sell. What I notice is that there's very little guidance, if any guidance, there's this grayness. And when there's grayness, some people move more aggressively and some people get less aggressive. With the de minimis side of things, we heard about five loans a year and all that kind of stuff and how many loans you make a year. What do you see in trends there? That's number one, and number two is, on the 30/60/90 day holding period in season and sell, what are you seeing? And I'll see if it's consistent with what I've been seeing.

Sam Riesenberg:

I don't know that I want to be held to numbers on a podcast.

Patrick Brooks:

Yeah, don't do that. Don't do that.

Sam Riesenberg:

But what I will say is to answer your first question, absolutely, I think that there's been a general trend in the industry to push the limits a little bit more. That there hasn't been a lot, if any, almost audit activity in this space. There certainly hasn't been a focus by the IRS in this. So when you look next door and you see that somebody's not getting in trouble for doing something a bit more aggressive, maybe the next time around, you're going to consider the same thing. That certainly, we've had a hard time trying to figure out where that line is, I'd say, for a number of years, and the entire community has been trying to figure that out.

I think that that trend is probably reversing itself in the last six months or so as a result certainly of the YA Global case hanging over, but even more so because of this audit announcement that people have been saying, "Look, I think there's going to be a bit more audit activity in here. Do I want to be the person that is most aggressive out in the market when the IRS comes calling?" And everyone's really trying to figure out where the line is, or at least certainly where the market is to try to analyze that.

Patrick Brooks:

Yeah. I see more clients historically from where they even were before which was generally conservative to even more with their attorneys leaning towards the direction of, "Hey, let's not be as aggressive because it is an area that we don't know as much of what's going on." So we see something come out like YA Global. So maybe the last part, see if you know the answer to this question, when it comes to treaty structures, what is the one area that we see people sometimes ignore? So there's a question for you, see if you get it right, because I know one that you work on a lot. What is something that you see people maybe not ignore, but sort of get surprised about when they're doing treaty structures?

Sam Riesenberg:

There's a couple different places, but the number one issue is definitely state and local tax.

Patrick Brooks:

Bam, you got it.

Sam Riesenberg:

Yeah, I passed the test. This is always surprising. The common way this is approached is someone comes in and says, "I want a treaty structure." And we say, "Okay." And they're like, "Yeah, I'm sold on it. That's what I want." And I said, "Well." So we sit down and talk with them. We say, "Okay. And you know you're going to potentially still pay state and local tax because the jurisdictions you're looking to lend into or you have operations in, those states don't follow the treaty position from a federal perspective." And that oftentimes is a real surprise because sometimes it's the fund setting up a separately managed account and the separately managed account owner is the one that was all set on a treaty. But then when they run the numbers, it's not the best structure for them. Or they're just surprised by all the filings that might need to be done or the different tax elements. And that is usually just... I'm just surprised at how many people are just completely surprised by the level of analysis that needs to go in to state and local tax piece of a treaty structure.

Patrick Brooks:

Well, that's perfect, Sam. So I think for today, we're good. We've covered audit activity. We've covered trends and structuring. Anything else you want to add to this? Or do you think we're good to close out?

Sam Riesenberg:

Look, I think the one thing I'll say is when you're looking at forming a credit fund, it's always starting from the beginning, right? Because there's always something that the manager wants. There's always something that the investors want. Your particular remit and the way that you're going about it is going to dictate your particular structure. And I've worked on a lot of structures, not a single one of them is the same. So there's a lot to think about as you're going into it.

Patrick Brooks:

Fantastic, Sam. Well, thank you so much for your time. Thank you everyone else for your time listening. And we're going to have our third podcast coming out sometime over the next month, which may cover updates on YA Global or other types of trends that we're seeing in the credit funds industry. Thank you all very much for your time. Take care.

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