Jones Day Tax Practice: Private Credit

The Trends

The private credit market, encompassing privately negotiated loans made by institutions other than banks, has experienced exponential growth. Currently valued at $1.7 trillion, it is projected to reach $3 trillion by the end of the decade. It offers attractive opportunities for both lenders and borrowers and evolving tax challenges necessitating careful planning.

Some key tax issues that may arise include:

Withholding taxes. Interest withholding taxes, which can reduce the lender's net return and increase the borrower's cost of capital, may be imposed depending on the applicability of tax treaties in the jurisdiction of the borrower and lender. Factors include loan terms, choice of entity, and the availability of any exemptions or reductions under domestic or treaty provisions. Lenders in this market may be eligible for the "portfolio interest exemption" from withholding tax on U.S.-source interest payments, which is only available to non-bank lenders. However, this exemption requires that the lender does not directly or indirectly own 10% or more or the voting stock of the borrower, which may pose a challenge for deals with an equity kicker or other equity component.

Investor tax sensitivities. Private credit funds that originate loans are considered to be engaged in a U.S. trade or business for tax purposes, impacting their investor base. Non-U.S. investors may become subject to U.S. tax and filing requirements for loan origination and other effectively connected income (ECI). U.S. tax-exempt investors in loan origination funds risk becoming subject to tax on their unrelated business taxable income (UBTI). Structural solutions such as blockers may be required, while U.S. taxable investors generally prefer to avoid blockers to limit fund-level taxation. Alternatively, some non-U.S. lenders may employ a "season and sell" strategy to avoid ECI whereby a U.S. lender will originate a loan to a U.S. borrower and then sell it to a non-U.S. buyer after a certain seasoning period, on the view that avoiding origination activities shields the non-U.S. buyer from ECI.

Lending tax traps for the unwary. Some rules deny or limit the availability of interest deductions for the borrower, such as the applicable high-yield discount obligation (AHYDO) rules, punitive rules applicable to debt not in registered form, and the general limitation on deductibility of business interest expense to 30% of EBITDA. Lenders may realize taxable income without a corresponding receipt of cash in connection with transactions that involve original issue discount, paid-in-kind interest, or equity kickers. Restructuring, refinancing, amendment, and debt exchange transactions can trigger taxable cancellation of debt income.

How We Can Help

Jones Day has a dedicated and experienced team who advise private credit participants on all tax aspects for lending transactions. Our tax team collaborates on a day-to-day basis with our finance, regulatory, and private equity lawyers who are expert in this space. We can help:

- Design and implement tax-efficient structures for lending vehicles attuned to your objectives and investor tax sensitivities, as well as legal, regulatory, and market conditions in relevant jurisdictions.
- Identify and evaluate tax implications of loans and other financial instruments, including cancellation of debt income resulting from amendments and restructurings involving distressed debt.
- Negotiate and draft tax provisions in fund documents, loan agreements, and related documents.
- Navigate complex and dynamic tax treaty network and ensure you qualify for and claim appropriate treaty benefits, while complying with rules and procedures in all relevant jurisdiction.
- Avoid or manage ECI or UBTI exposure for tax-sensitive investors.
- Execute and document transactions in a manner that supports your tax position and minimizes your tax risks.
- Resolve any disputes or controversies with the taxing authorities.

Who Will Be Impacted?

Impacted institutions include asset managers exclusively dedicated to managing credit funds; private equity funds with a separate private credit strategy; and investment banks, commercial banks and insurance companies with asset management affiliates managing or partnering with private credit funds. Careful tax planning is necessary to optimize after-tax returns, minimize tax risk, and navigate cross-border regulations. Companies that access private credit for financing must consider tax arrangements to make informed decisions.

Key Contacts

For further information regarding our Tax Practice, please contact your principal Firm representative or one of the lawyers listed below.

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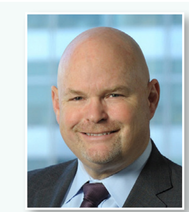
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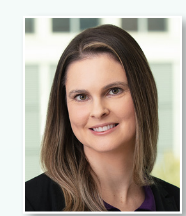
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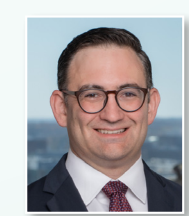
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