KPMG

# Ireland for credit:

## Emergence of the ICAV as vehicle of choice for US-focused credit strategies

# Introduction

The private credit industry has experienced significant growth over the past decade, evolving into a critical component of the global financial system. The asset class exceeded $2 trillion in AUM during 2024 and is expected to exceed $3 trillion over the coming years, driven by the retrenchment of traditional banks from leveraged lending and the ongoing expansion of the credit businesses of private equity firms.

From a European perspective, AIFMD 2.0 introduces a pan-European loan origination framework for the first time, levelling the playing field for EU domiciled funds, which is expected to eliminate barriers to cross border direct lending that we have seen in recent years. In tandem with this, the democratisation of alternative investment strategies and resultant demand for evergreen / hybrid type strategies is expected to drive the continued growth of the private credit industry.

Ireland is uniquely positioned in the context of certain specific credit strategies, in addition to more generally as one of the leading global domiciles for investment funds. There are a number of reasons fund managers select Ireland to domicile their fund, including the well-established service provider ecosystem (particularly in the context of credit), connectivity, common law system, regulatory framework and investor perception. In addition, from a tax perspective, Ireland has a broad tax treaty network with 75 treaties currently in effect.

In recent years, a number of fund managers have established an Irish ICAV in the context of US direct lending strategies. In addition, ICAVs are also being utilised for a variety of strategies. This document explores the rationale for this trend – the unique characteristics of an ICAV which has made it the go-to for many credit managers and what is practically required to achieve the tax efficiencies that an ICAV can bring.

This document is focused on tax considerations only. Legal and regulatory considerations also need to be assessed in the context of any decision to utilise an ICAV.

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# US direct lending strategy – an overview of the tax complexities

There is one fundamental principle that is critical to note in the context of a non-US entity which is engaged in any level of activity in the US – this activity can give rise to a US trade or business for the non-US entity which can trigger a US tax filing requirement, in addition to resulting in unanticipated tax liabilities. Applying this principle to an investment fund: if it engages in a certain level of activity in the US, it can trigger a US trade or business for the fund which, depending on the classification of the fund for US tax purposes, can result in a filing obligation arising for investors. The need to file a tax return in the US may be seen as administratively burdensome by non-US investors, so a key consideration in structuring a fund is ensuring that it does not unintentionally create a US trade or business for tax purposes.

For many funds, US trade or business risk isn't a significant concern as there is a safe harbor which will allow a non-US fund to engage a US manager without triggering a US trade or business for the fund. However, this safe harbor only applies to certain types of investment activity. For example, it will allow an unlimited amount of trading in most securities or fully funded loans (i.e. secondary acquisitions) at the discretion of a US based investment manager. However, loan origination does not fall within the scope of this safe harbor. As a result, it is necessary to consider whether any loan origination activity (e.g. negotiating with and lending to underlying borrowers) carried out in the US could trigger a US trade or business for a non-US entity such as a fund.

There is no hard-and-fast rule regarding how much loan origination activity can be carried out in the US without giving rise to a US trade or business. Whilst a lower number of loans (e.g. less than five per annum) can be indicative of lower risk, there are other factors that need to be considered such as physical presence, time / effort spent on negotiating, etc. In addition, supplementary work post-investment, such as a workout in a distressed scenario, can increase the risk significantly. Given the potential risk for funds (and in some cases their investors), managers typically prefer to have as much certainty on US trade of business risk as is possible.

## There are three main approaches that are used in practice to manage this risk:

### 1. US blocker

US loans are originated through a US corporate vehicle which is subject to US Federal Income Tax on return earned, which protects the non-resident fund from any US tax exposure. In most cases leverage is used to try and manage the level of US tax, however, there is normally some US tax leakage.

### 2. Season & Sell

US loans are originated by a US vehicle and held for a period of time before being sold to the non-resident fund. The broad aim of this approach is to ensure the non-resident fund is acquiring funded loans which qualify for the safe harbor mentioned above, therefore ensuring that a US trade or business does not arise. This approach requires detailed operational guidelines to be implemented and followed.

### 3. Treaty structure

US loans are originated by a vehicle which qualifies for the benefits of a tax treaty with the US. Where this is the case, the fund can rely on protection in the treaty to ensure a US trade or business does not arise for it as a result of the loan origination activity carried out in the US.

This document focuses solely on the use of an ICAV in the context of sceanario 3 above – specifically, what is required in order to implement a treaty-based structure.

# ICAV as a treaty vehicle for US direct lending

The key reason that the ICAV has become the go-to vehicle in the context of the treaty-based approach is the fact that it can, subject to meeting specific conditions, access the benefits of the Ireland-US Double Tax Agreement. This is based on the provisions of the Ireland-US Double Tax Agreement under which an ICAV can be regarded as a "resident" for the purposes of the Double Tax Agreement and therefore, in principle, access the benefits of the Double Tax Agreement. This clause removes subjectivity which would otherwise exist as it typically isn't clear that a tax-exempt fund vehicle can be so regarded.

Under the "Permanent Establishment" clause of the Double Tax Agreement, an Irish ICAV should only have a taxable presence in the US where it carries on certain activities. The range of such activities is narrower than those which would give rise to a US trade or business. As a result, the Permanent Establishment article will mean that the ICAV will not be treated as having a taxable presence in the US, even though it might have been so regarded under US domestic tax law.

From a practical perspective, access to the Double Tax Agreement and protection from a US trade or business arising is only possible where all of the following requirements are satisfied:

1. The ICAV must be generally tax resident in Ireland – this is straightforward to manage in practice;
2. The ICAV must have good ownership in the context of the Ireland-US Double Tax Agreement. This is usually satisfied through the ICAV having either (i) greater than 50% US or Irish investors, or (ii) fewer than seven investors holding 95% of its interests, provided those investors are in EU / USMCA jurisdictions that can access a Double Tax Agreement between the US and their jurisdiction of residence; and
3. The US-based manager must be legally and economically independent of the ICAV, which can require some operating parameters to be put in place in practice across a range of factors, depending on the anticipated operating strategy.

Where the above three tests can be satisfied, it should be possible for the ICAV to appoint a US-based manager to engage in loan origination activity without triggering a US trade or business for the ICAV. US states are not required to follow Double Tax Agreements so state tax and filing obligations can still arise in some cases.

# Tax profile of an ICAV

Aside from its ability to access the benefits of the Ireland-US Double Tax Agreement, an ICAV is generally a very tax efficient vehicle. Key features of the ICAV in this regard include:

- Entity level exemption from tax – no Irish tax applicable to investment return (income or gains) arising to the ICAV.
- No withholding tax on payments to non-Irish investors in respect of their investment, provided a non-resident declaration is in place.
- Exemption from Irish VAT in respect of investment management fees and an ability to recover any VAT arising (e.g. in respect of legal or audit fees) based on the proportion of non-EU assets held (e.g. a strategy solely focused on US loans will normally have almost 100% VAT recovery).
- A broad tax treaty network including 75 treaties currently in effect.

At a broad level, this means that a 0% effective rate of tax can be applicable to an ICAV engaged in US direct lending, given that (i) no US withholding tax should apply to return, (ii) there is no entity level taxation applicable to the ICAV and (iii) there is no withholding on payments to non-Irish investors.

An ICAV is a regulated vehicle, so does come with a degree of additional establishment and operating cost. However, this regulation does open the opportunity to attract additional capital from EU-based institutional investors and, in practice, is not as significant as the cost of establishing a highly regulated vehicle, such as a Business Development Company, in the US.

# ICAV for other US strategies

An ICAV which is eligible for the benefits of the Ireland-US Double Taxation Agreement can also provide a tax efficient option in the context of US-focused strategies broader than direct lending. For example:

## Royalty strategies

US source royalties are normally subject to 30% withholding tax. However, the Ireland-US Double Tax Agreement can reduce this to 0%, meaning it is possible to achieve an overall low effective rate of tax in a similar manner to a US direct lending strategy. There have been a number of music and medical device royalty funds established as ICAVs for this reason.

## Equity-focused fund

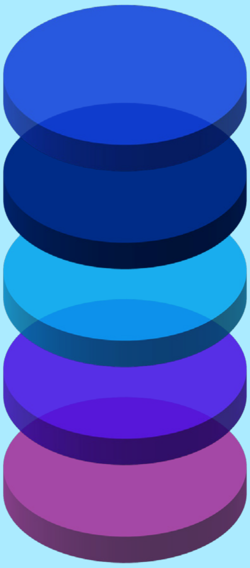
The rate of US withholding tax applicable to dividends is normally 30%. However, the Ireland-US Double Tax Agreement allows this to be reduced to 15% (or 5% in cases where there is a 10%+ ownership interest);

In this context, it is important to note that only 1 and 2 of the conditions noted in the context of US direct lending funds on page 5 need to be satisfied i.e. there is no need for a US manager to be legally and economically independent of the ICAV in the context of the above strategies.

# KPMG Ireland's private credit offering

Our multidisciplinary team of experts across audit, tax, consulting and deal advisory are able to advise you across the full life cycle and value chain, irrespective of whether you are an asset manager, service provider or investor. We work on a global basis – working closely with credit experts in key jurisdictions such as the UK, Luxembourg and the US to bring a global solution.

We have expertise in respect the full range of strategies which form part of private credit:



**01** **Direct lending**

**02** **Distressed debt / NPLs**

**03** **Mezzanine debt**

**04** **Special situations**

**05** **Asset backed lending & speciality credit**

Our teams have deep industry knowledge and access to a global network of professionals, ensuring that we provide comprehensive insights and solutions tailored to the evolving credit landscape.

### Fund structuring

- Fund formation – tax structuring
- Carried interest planning
- Accounting advisory
- Regulatory advice
- Target operating model

### Life cycle

- Tax compliance
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- Value creation

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- Due diligence – tax, legal, ESG & commercial
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- Transaction review
- Tax structuring
- Turnaround / restructuring
- Workout solutions
- Cash flow / financial monitoring and modelling

### Exit

- Tax structuring
- Pre-sale readiness assistance
- Restructuring / advisory
- Insolvency / liquidation

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