Brexit done: Tax implications for private credit funds

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Since the GFC, private credit as an asset class has benefited from a conjunction of multiple factors from stricter regulatory rules for banks to investors' quest for yield. It has grown significantly in the US and in Europe and has attracted huge flows of capital over the last years. Traditionally, the UK has been one of the hottest markets in Europe for private credit, which fund managers have invested billions of GBP into, despite the looming threat of Brexit. Pan-European as well as UK-centric credit funds have often been established in Luxembourg as investment platforms, holding diversified pools of credits and relying on well-known and understood operational structures.

One of the important aspects of structuring private credit funds is taxation. Taxation at source in the UK in the form of withholding tax (WHT) on interest payments, as well as the VAT recovery right at fund level in Luxembourg, have been monitored in the wake of Brexit and its anticipated impact. Now that Brexit has indeed happened, what are the changes affecting private credit funds and their tax positions? We cover some of these aspects below, while additional regulatory and related tax comments will be part of our next article of our private debt series.

UK withholding tax

As a general rule, UK tax laws apply a 20% deduction on interest payments made by incorporated companies to non-UK residents. While the loan agreement signed between the corporate borrower and its lender generally includes a gross-up clause, the WHT issue must be addressed, with several solutions being available.

One of those is the Qualified Private Placement exemption (QPP) which entered into force in 2016. Under this domestic UK provision, subject to certain conditions, qualified lenders may benefit from WHT exemption on the interest payments from a UK source. Another useful relief option is to rely on a double tax treaty (DTT) concluded between the UK and the jurisdiction of the lender. European credit funds often finance and hold a fully taxable Luxembourg subsidiary which holds the assets, collects the payments and manages the credit portfolio. With adequate substance and activity, these subsidiaries can often benefit from the above exemptions when properly structured and operated. When funds are established as tax-exempt entities, or under the legal form of a partnership, the application of these rules is sometimes more complex and requires specific attention and analysis.

Since these UK WHT exemptions derive either from the UK domestic tax law or double tax treaties in place, and do not rely on EU directives or rules, they should remain available despite the UK leaving the EU.

Corporate tax at fund level

As mentioned above, many global credit and special situations managers structure such investments using one or several SPVs, which are often taxable corporate subsidiaries holding a diversified portfolio of credit securities. These SPVs are typically financed with debt and interest charges on such debt are, in principle, deductible from the taxable basis of the SPV under certain conditions, in particular under the EU-wide implementation of the Anti-Tax Avoidance Directive (Directive (EU) 2016/1164 of 12 July 2016)[1].

For most fund structures, Brexit will therefore not have any impact on the taxation at fund level.

VAT

Brexit might have a positive impact on the VAT position of Luxembourg SPVs and credit funds earning financial income from the UK.

(i) VAT impact on Luxembourg SPVs

Generally, financial services (notably the loans granted) are VAT exempt with no VAT recovery right when provided to EU counterparts. The same services rendered to non-EU counterparts are also VAT exempt but grant a VAT deduction right. Therefore, Brexit has a positive impact on the input VAT recovery right of SPVs performing financing activities with UK borrowers.

Prior to 1 January 2021, the granting of interest-bearing loans by Luxembourg SPVs to UK borrowers was a VAT exempt activity with no VAT recovery right. As a consequence, such an SPV was not entitled to recover input VAT charged by Luxembourg service providers or declared as due on VAT taxable services received from abroad. That input VAT was therefore a final cost.

As from 1 January 2021, such a Luxembourg SPV is now entitled to fully recover input VAT incurred on costs linked to its UK financing activities. Input VAT declared as due on services received from abroad, as well as VAT charged by Luxembourg service providers, is now deductible when linked to the UK financing activity.

Brexit may also have an impact on the VAT compliance obligations of Luxembourg SPVs with UK financing activities. Prior to 2021, these SPVs were, in principle, registered under the simplified regime (when having Luxembourg VAT compliance obligations). Under that VAT registration format, SPVs only had to file one annual VAT return per calendar year and to pay the Treasury the Luxembourg VAT on taxable services received from abroad. Post Brexit, Luxembourg SPVs with non-EU financial income will either have the obligation to modify their VAT registration format (from the simplified regime to the standard one) or to VAT register under the standard VAT regime (if not already VAT registered). Under the standard regime, SPVs will have to file both periodic (quarterly or monthly) as well as annual recapitulative VAT returns.

Since any additional VAT compliance burden should be offset by the right to recover input VAT, Brexit should have a positive impact overall on SPVs having financing activities with UK borrowers.

(ii) VAT impact on Luxembourg credit funds

Luxembourg credit funds typically provide debt financing to Luxembourg SPVs which, in turn, perform the UK financing activity. Such Luxembourg financing to the SPVs is VAT exempt with no VAT recovery right. Credit funds are therefore, in principle, not entitled to recover input VAT declared as due on taxable costs received from abroad, as well as Luxembourg VAT incurred on their Luxembourg running costs.

At first glance, Brexit has therefore no direct impact on the VAT position of Luxembourg funds granting financing to Luxembourg companies. Nevertheless, and under certain conditions, Brexit coupled with the possibility to set up a VAT group could constitute an opportunity to mitigate VAT leakages and to improve the VAT position of the Luxembourg investment structure as a whole.

Luxembourg financial sector players may indeed opt to implement a VAT group encompassing the Luxembourg credit fund and the Luxembourg SPV(s) having the financing activities with, notably, the UK borrowers. Close financial, economic and organisational links have to exist among the companies in order to set up a VAT group. The implementation of such a VAT group would entail the main following consequences:
- the VAT group would be considered as a single VAT taxable person;
- transactions between the Luxembourg credit funds and SPVs would be outside the scope of VAT (and therefore not subject to VAT);
- the VAT deduction right is determined at the VAT group level considering the overall activities carried out by the group members with third parties.

Therefore, and given that the activities carried out by the VAT group members with third parties would consist (notably) in the financing activity with UK counterparts, setting up a VAT group post-Brexit should have a positive impact on the VAT deduction right of Luxembourg investment structures as a whole and could also limit its VAT compliance burden (one reporting obligation at the level of the VAT group instead of at the level of each member).

For setting up a VAT group for Luxembourg credit funds and their SPVs, it is firstly necessary to examine whether or not the formal requirements of the VAT law are met and, should it be the case, determine if that solution is relevant to optimise the VAT position of the investment structure.

Conclusion

From a VAT perspective, Brexit has a positive impact on Luxembourg credit fund structures having financing activities with UK borrowers. Asset managers should also be able to rely on the existing exemptions to address WHT risk in the UK, while being conscious of the rapidly changing tax landscape in Europe and the new layers of complexity relating to the structuring of private credit funds.

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1) See "Luxembourg tax authorities release guidance on interest deduction limitation rules", by Antoine Dupuis & Andreas Medler, AGEFI, February 2021.