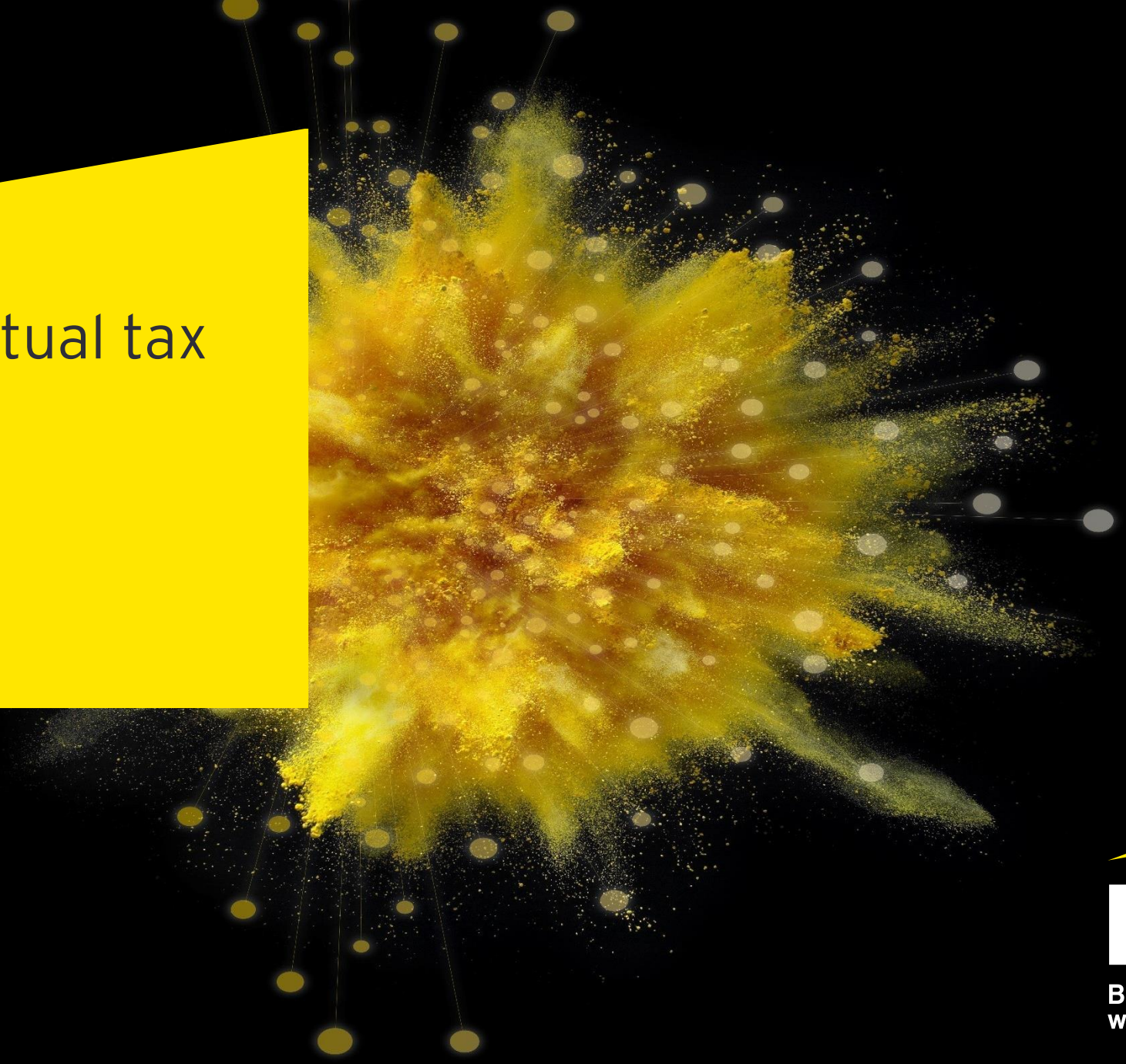
Credit funds: virtual tax series

Session 3

Tuesday, May 26, 2020



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Today's agenda

The COVID-19 crisis continues to have a profound impact on the global credit markets. Such significant dislocations are creating opportunities in the markets, while also requiring funds to navigate potentially complex tax issues where debt issuers are in distress. In this session, we will explore current European deal structures and the related tax considerations, while also taking a closer look at market trends in energy & infrastructure, and some of the tax considerations unique to the industry.

During this session, we will focus on the following key areas in current credit markets and the resulting tax considerations.

01 Current deal structures in Europe and related tax considerations

02 UK tax considerations on debt to equity conversions and key themes in Europe

03 Current market trends in energy and infrastructure investments

04 Investor considerations in debt to equity conversions

05 Tax basis preservation

06 Select considerations for partnerships in debt workouts

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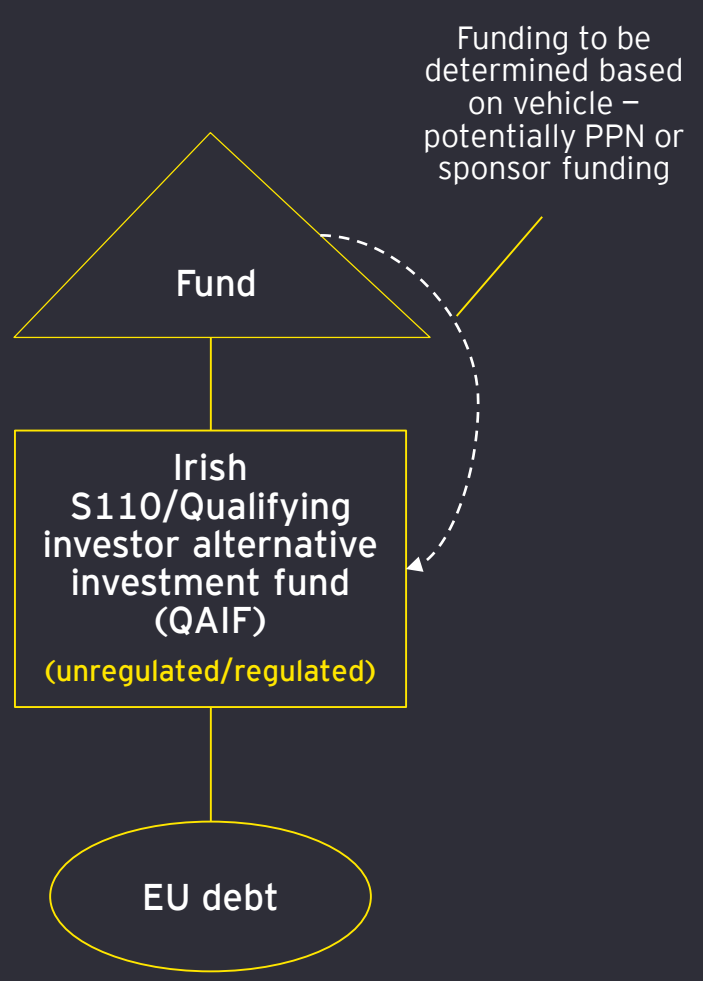
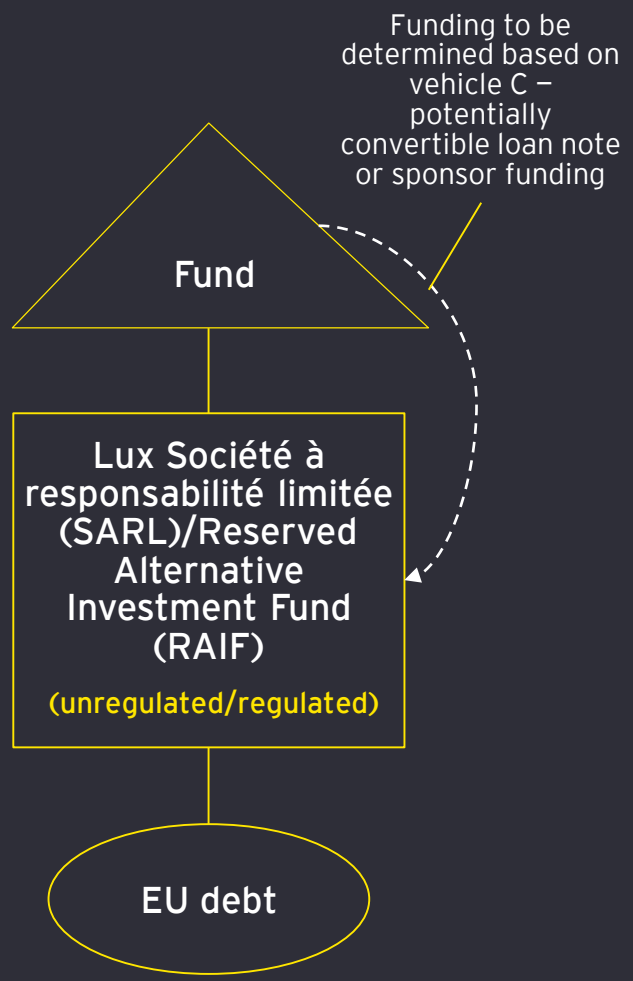
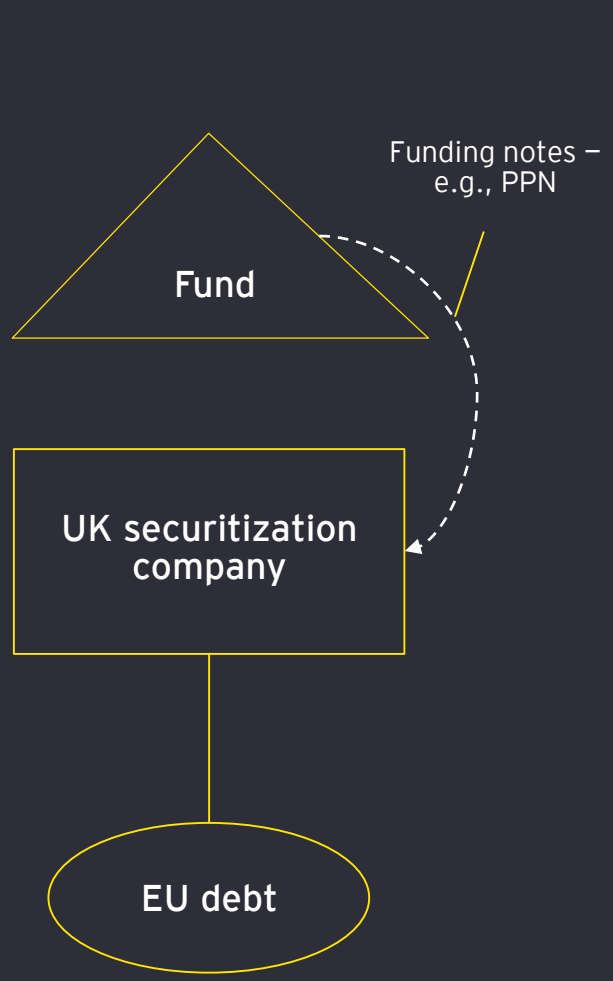
Example European fund structures







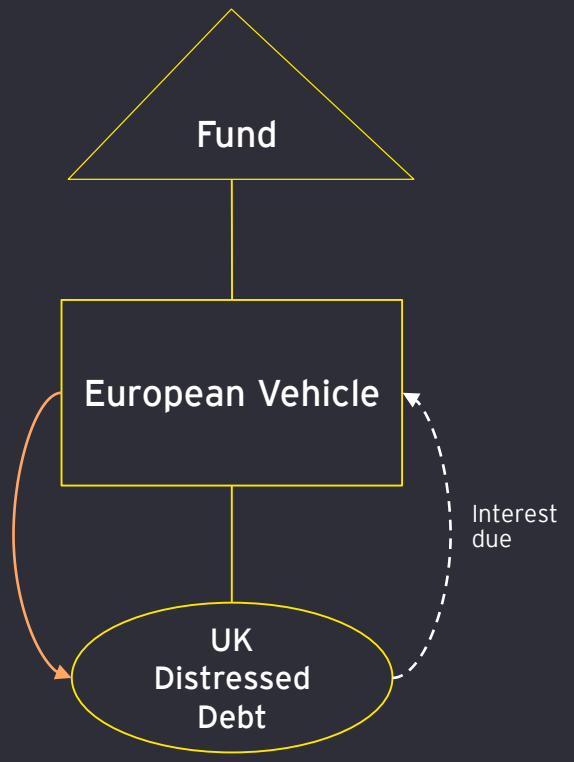
Key tax considerations for European fund structures

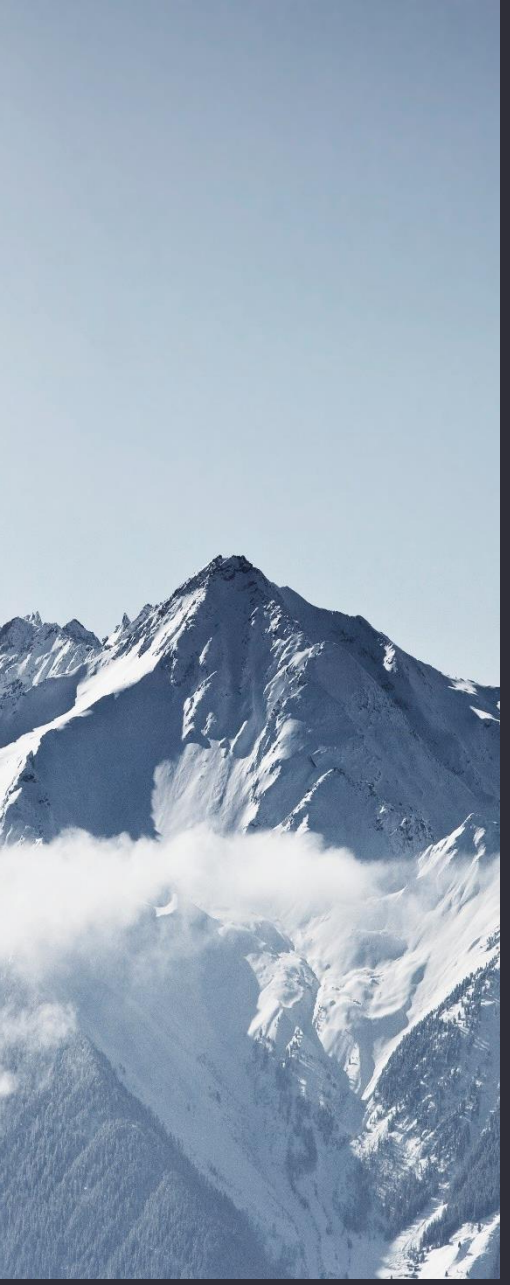
There are various tax factors to consider while navigating ongoing changes to tax legislation across Europe:

- Entitlement to treaty benefits – beneficial ownership/multilateral instrument (MLI)
- Interest withholding tax on payments by platform vehicle
- Taxation of pull-to-par profits
- Impact of ATAD, in particular, introduction of:
  - Interest limitation rules
  - Anti-hybrid rules
- Consider appropriate transfer pricing on funding instruments
- New reporting requirements under DAC 6/Mandatory Disclosure Regime (MDR)

UK tax considerations on debt restructuring

Focus area	Potential actions	Tax considerations
Debt restructuring	1 Amendment, extension or renegotiation of current loan facilities	Potential adverse tax implications where there is a substantial modification" of debt
	2 Full or partial debt release	What is substantial?
	3 Debt to equity swaps	Debt releases and debt-for-equity swaps are prima facie taxable, but statutory exemptions available: - Insolvency - Corporate Rescue Exemption
Distressed debt acquisition	Repurchase of debt at a discount	Consider anti-avoidance rules where acquiring connected party debt at a discount Statutory exemptions may be available Review structuring options to mitigate tax exposure





European tax considerations on debt restructuring

	France	Germany	Spain	Italy
Amendment, extension or renegotiation of current loan facilities	No tax charge where amendments are arm's length and the changes do not impact amount / legal classification of facility P&L credits on amendment generally taxable	No tax charge where amendments are arm's length and the changes do not impact amount / legal classification of facility	No tax charge where amendments are arm's length and the changes do not impact amount / legal classification of facility P&L credits on amendment generally taxable	No tax charge where amendments are arm's length and the changes do not impact amount / legal classification of facility P&L credits on amendment generally taxable
Full or partial debt release	Waiver taxable to issuer, unless debt is held by parent company and waiver not deductible, and issuer commits to increase its share capital within 2 years (by at least the same amount)	Waiver of third party debt are taxable for issuer unless qualifying for restructuring exemption. Debt releases on intercompany debts potentially tax neutral unless debt has already been impaired	Debt releases / waivers may result in adverse tax implications for issuer	Debt releases / waivers may result in adverse tax implications for issuer unless certain exemptions (e.g. bankruptcy) apply
Debt to equity swaps	Where debt was acquired at a discount, should be taxable to the issuer, unless swap is effected at nominal value	Potentially tax neutral unless debt already impaired. Conversion of impaired intercompany debt leads to a taxable gain at level of the debtor (unless qualifying for restructuring exemption)	Where the swapped debt was acquired at a discount, the discount should be taxable	Potentially taxable

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Market trends in energy & infrastructure

- Already a period of intense volatility with rampant geopolitical, technological, regulatory, social and even biological challenges.
  - Oil price collapse due to Saudi Arabia – Russia price war
  - COVID-19 causing unprecedented demand shocks on a global basis.
  - Uncertainty is the only constant!

- As a result, many energy companies are facing financial distress in the form of insufficient / declining cash flow to meet obligations, liquidity constraints, maximized asset leverage, etc.
- Adding further pressure, many of these companies will be subject to borrowing base redetermination and/or debt maturity in the near term. Accordingly, many such companies and their sponsors have begun negotiations with their lenders and are considering strategies to help them manage through this down cycle.

Key tax topics for non-US debt investors

- Investor consequences of changes in the terms or type (debt vs. equity) of an existing investment in a workout or bankruptcy
  - Triggering a loss vs. preserving tax basis for the new investment
- Prevalence of tax partnerships in US oil and gas
  - Debtholder incentive – avoiding US effectively connected income (ECI)
  - Equity owner incentive – avoiding cancellation of indebtedness (COD) income
  - Structuring alternatives to address issues

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Debt for debt/equity exchanges

Deemed exchange of old debt for new debt

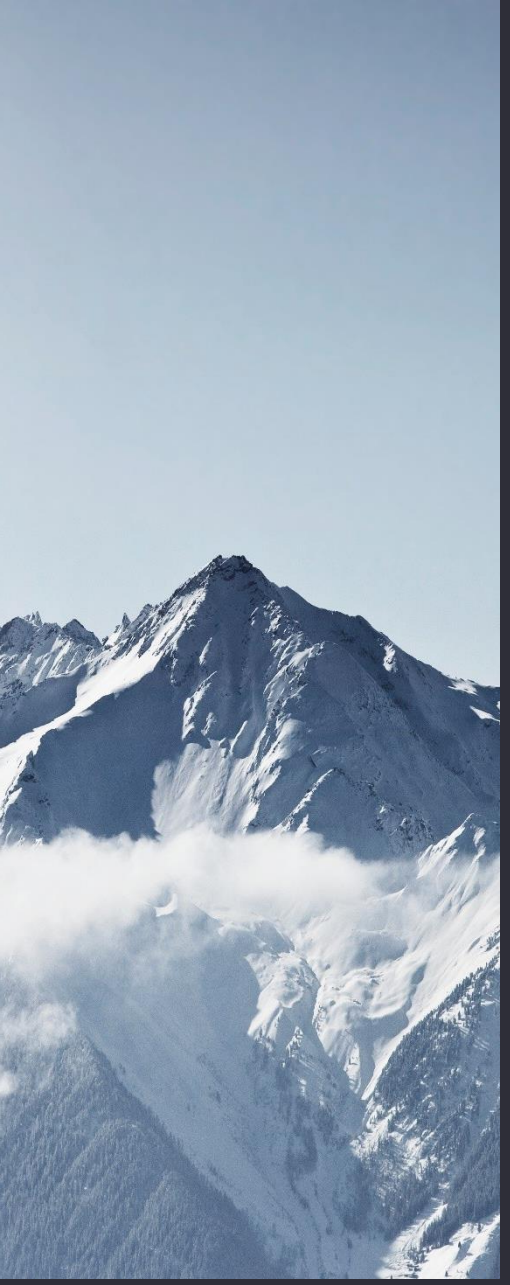
- Changes to the terms of a debt can cause it be treated as exchanged for "new debt"
- The "deemed exchange" of old debt for new debt may be taxable, trigger a loss to the holder and a new (lower) tax basis, and additional OID (potentially subject to withholding tax)

Debt for equity exchanges

- Exchange is generally tax-free if existing debt is a "security" and taxable otherwise

Key tax considerations

- Varying investor sensitivities and objectives
- Benefit of tax basis preservation vs. loss recognition
  - Foreign Investment in Real Property Tax Act (FIRPTA) "cold" for "hot" exchange
- Getting ahead of the plan/DIP financing considerations
- Future tax reporting considerations



Tax basis preservation for non-US investors

- Avoiding whipsaw
  - **Withholding tax.** As a result of taxable exchange, may have to accrue taxable OID equal to difference between original investment and face – paying tax on invested capital
    - Portfolio interest exemption and treaty exemptions may eliminate this issue
  - **ECI.** As a result of a taxable exchange, can only claim tax basis against go-forward ECI equal to value of investment on date of exchange (rather than full amount of investment)
- Reporting considerations
  - What to expect when expecting a K-1
    - Timing of information
    - Activity reporting
    - Footnote only items
  - Preserving future deduction allocations
  - Investment modeling changes
  - Other

Tax partnerships in US oil and gas

Why?

- IDC deductibility – potentially limited benefit to a stand-alone oil and gas corporation – of potentially greater benefit to equity investors

Tax challenges for partnership debt workouts

- COD income exclusions generally determined at the partner-level and therefore much harder to satisfy
- Debt liability "allocated" to the owners and changes in terms of the debt (or admission of a creditor as an equity owner) can cause taxable "shifts" among owners even if the debt "principal" amount stays constant
- Debtholders that become equity owners may be allocated ECI on a go-forward basis
- Valuation is a critical start to the profile of the investment going forward

Strategies to address tax challenges for partnerships

- Incorporation transactions
  - To benefit from COD income exclusions
  - Block ECI for new equity owners
- Generating losses to offset equity owners' COD income
  - Asset-level transactions (Section 1231 treatment)
  - Issues relating to lower-tier partnerships
  - Abandonment
- Other

What are the key takeaways from this webcast?

1-minute recap

Speakers

Mark Boyle

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Mark is a Partner and leads EY's Financial Services International Tax and Transaction Structuring Tax team across EMEIA. He has over 15 years' experience in advising on and managing the tax aspects of domestic and cross-border M&A transactions.

Mark advises a wide range of clients on transactions in the financial services sector, with a particular focus on structuring and implementing transactions for private equity and credit fund clients.

Mark was awarded an MA in Law from Cambridge University and a Certificat des Études Juridiques Françaises from the Université de Poitiers, France, while he has also authored technical publications such as the tax chapter within the leading textbook "Restructuring Law & Practice".

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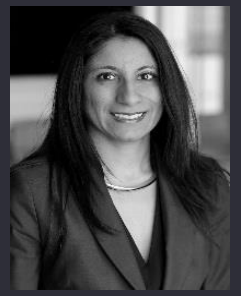
Darrin leads EY's EMEIA FS Private Equity funds team, overseeing delivery of tax advice and compliance services for global private equity, credit, infrastructure and venture fund start-ups and transactions. He specializes in buyout, debt and credit, and alternative asset class funds. He has 15 years of experience advising on the tax structuring of credit, private equity, infrastructure, debt and venture capital funds.

Darrin has vast experience in improving the tax efficiency of existing fund structures and advises on transaction due diligence and structuring. He also provides tax advice on the establishment of global private equity management groups, including maximizing post-tax profit participation, modelling, transfer pricing and the documentation process. Darrin also has expertise in developing the terms for carried interest arrangements and tax planning opportunities to improve post tax return of carried interest.

Speakers



Tina Ganatra

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Tina is a Partner in EY's Financial Services group with 19 years of experience in advising a wide range of clients on various tax assurance, technical tax and transaction tax matters.

Tina leads various global teams on tax due diligence transactions, pre/post transaction structuring, post-transaction integration and restructuring programs. In addition to her extensive experience providing Merger and Acquisition buyside and sell-side tax advice, she has lead major Brexit restructuring programs for global banks and various global asset managers, while also advising various Private Equity, Sovereign Wealth and Family Offices through key transactions.

Speakers

Chris Lallo

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Chris Lallo joined the Houston office of Ernst & Young LLP in 2008 and led the transaction tax practice for the Southwest region from 2009-2019. His practice is focused on both domestic and international tax matters, with broad-based experience in the area of tax planning related to domestic and cross-border mergers and acquisitions, including taxable and nontaxable transactions, cross-border investments, financing structures, withholding issues, and securities offerings.

Chris has significant experience in advising domestic and international energy companies in connection with upstream, midstream, downstream and oilfield service company transactions and Chris has worked on many of the largest inbound oil and gas deals that have been completed over the past decade. Chris also works with a number of large energy and infrastructure focused private equity funds throughout all stages of their investments, from fund formation and initial portfolio company structuring through monetization events, and Chris has substantial experience in working with credit and private equity funds in connection with issues related to distress or debt restructuring events. Chris also has significant experience in mining, petrochemicals and other transactions in the natural resources sector. Chris has also worked on a number of public monetization transactions in the natural resources sector.

Elizabeth Bowman Crawford

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Liz has spent 20 years serving corporate and partnership clients, focusing on compliance issues, as well as on special projects, including research and experimentation studies, fixed asset management and MLP reporting considerations.

Liz has led the effort to develop and market a comprehensive depletion calculation tool that provides a maximized benefit of the IDC capitalization elections on a consistent, year-over-year basis. She has also worked closely to help coordinate tax information for Private Equity funded upstream oil and gas partnerships over the life of the investment through multi-office management and client relationship building. These activities have included partnership compliance, development of reporting templates and transaction modeling. Due to Liz's work experience, she has gained tremendous insight into the oil and gas industry, its tax reporting methods, especially for business entities, with a focus on asset-heavy companies and the tax reporting requirements of asset issues.

Speakers

Tim Devetski

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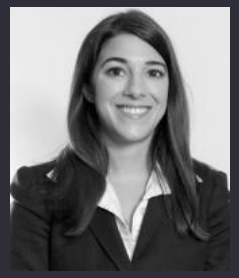
Tim's principal area of practice is federal tax law, with an emphasis on planning domestic and international business transactions. He has significant experience working with non-U.S. business and tax advisors in Europe, Latin America, the Middle East, and Asia. In addition to his transaction planning experience, Tim also has experience in resolving contested issues with the Internal Revenue Service and in tax litigation in various courts.

He serves as Principal in EY's Houston office.

Select Experience:

- MLPs - served as lead tax counsel for publicly-traded partnerships and their sponsors in various industries, including transportation, storage and terminal operations, refining, offshore drilling, and shipping
- Private Equity - served as lead tax counsel with respect to various partnerships, joint ventures, financings, mergers and acquisitions entered into by private equity funds and their portfolio companies
- Multinational companies - served as lead tax counsel for U.S. and non-U.S. based companies on the U.S. tax aspects of their international operations, including effectively connected income and withholding tax issues and issues relating to acquisitions and dispositions of U.S. real property interests, as well as subpart F, interest allocation, and overall foreign loss issues



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Mitra is a senior manager in Ernst & Young's Houston office in the International Tax and Transaction Services – Transaction Tax Advisory group.

Mitra focuses on U.S. federal income tax planning and structuring for business transactions involving partnerships (including master limited partnerships) and corporations.

She has significant experience performing tax structuring, tax due diligence, and transaction advisory services for domestic, distressed, multi-national and international private equity and corporate clients primarily in the energy industry, including natural resources industries such as oilfield products and services, upstream, midstream (including liquefied natural gas) and downstream oil & gas. Mitra has represented investors and companies in various types of inbound and domestic oil and gas investments and transactions, including tax partnerships, limited partnerships, public monetization transactions, strategic divestitures, private equity fund considerations, and debt restructurings.

Mitra's industry experience includes oil and gas, petrochemicals, renewable energy, and metals and mining.

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