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Talking Asset Management with KPMG

IRS and State Audit Activity in Credit Funds

Below is a transcript of *Talking Asset Management with KPMG*. In this episode, **Jay Freedman,** Global Hedge Fund Tax practice leader, **Tom Greenaway,** Tax Controversy and Dispute Resolution Services Principal, and **Dilyana Antevil,** State and Local Tax Managing Director, discuss IRS and state audit activities with regard to credit funds.

Jay Freedman:

Hello, and thank you for listening to Talking Asset Management with KPMG. I'm Jay Freedman, and I'm the leader of KPMG's hedge fund tax practice. Today we're going to talk about both IRS and state audit activities with regard to credit funds.

Joining me today are Tom Greenaway, Principal in our Washington National Tax practice focused on tax controversy services and Dilyana Antevil, a Managing Director in our State and Local Tax practice. Tom and Dilyana, welcome.

Dilyana Antevil:

Thank you for having us, Jay.

Tom Greenaway:

Hi Jay.

Jay Freedman:

Alright, so let's jump right in. So guys, about three years ago we heard rumors about a credit fund, supposedly a season and cell structure, that was being audited by the IRS and we were questioning whether this would lead to a broader campaign.

Since then, it looks like the IRS is at least getting a bit more organized around this. Tom, can you give us some background on this and why the IRS is looking at credit funds specifically?

Tom Greenaway:

Sure, Jay. So foreign direct investment into the United States has grown by orders of magnitude and it really has not been examined or audited at all by the IRS over the past couple decades. The IRS has also not put out any guidance, so a lot of market practices have sprung up in that environment, and now the IRS says that they want to kind of shine a light on it.

Jay Freedman:

And Dilyana, have we seen the states follow suit?

Dilyana Antevil:

Yes, and we see audit activity that is focused on foreign loan originators because they often rely on 3Ds to which states do not conform. We also see activity focused on season and sell funds, and as you know, those funds they often qualify for favorable portfolio income treatment for federal purposes. There is similar treatment afforded in many states, however, states often question that. They are looking to determine whether the funds truly qualify for purchase loan exemptions or could be viewed as participating in the loan origination. They are also looking to assert nexus being created by the independent agent that is originating loans on behalf of the fund that purchases the loans.

Jay Freedman:

And when we say credit funds what I've been seeing is there's been a lot of funds that they've started to come under exam that aren't what I would consider credit funds.

They're funds that trade in debt, but often very liquid, government bonds, global macro-type structures. Do we have any insight as to how a fund selected for exam under this campaign?

Tom Greenaway:

So Jay, as you know, when our clients are selected for audit, oftentimes the exam teams themselves will say they don't even know why the return was selected and IRS is using telling saying publicly that they're using data and analytics to select these returns from a central, with a centralized team, but as we've seen across our cases, and as your question suggests, they're not hitting the right funds. It basically seems like any fund with a large amount of interest income, or you know, interest expense, is going to be at least, you know, in scope for these audits, and as your question suggests, that's just not a narrow enough focus to pick up the funds that actually have this issue.

Jay Freedman:

And Dilyana, from a state perspective, any insight?

Dilyana Antevil:

So similar to what Tom said, I don't think states are necessarily using as much data and analytics as the IRS does, however, they are targeting funds with a significant number of borrowers or economic presence in a state and given that economic nexus is the law of the land and most states host Wayfair, it's very easy for a fund to create nexus in a state and be on the state's radar.

Additionally, the credit fund industry is relatively young and it often relies on rules that were written for traditional banking lenders, be it source receipts, so there are often issues with applying those rules to the credit fund industry.

Jay Freedman:

And does being selected for a federal audit have anything to do with triggering a state audit?

Dilyana Antevil:

It depends on the issue. For example, if they are questioning season and sell fund, if it qualifies for portfolio income treatment, that has state implication because if it doesn't qualify for federal it doesn't qualify for state as well.

Tom Greenaway:

Yeah and Jay, let me just – some of our listeners may not know – but the IRS and lots of state tax administrators have memorandums of understanding where they agree to share information with one another, so it absolutely increases the likelihood of another audit if either the IRS has got a fund under examination, or vice versa, if a state tax administrator has a fund under audit.

Dilyana Antevil:

Great point, Tom.

Jay Freedman:

Thanks, Tom. Thanks. So there's a lot of issues associated with credit funds – everything from ECI to distressed and a whole lot more. Tom, do we have any sense of what the focus, at least from the federal level, has been?

Tom Greenaway:

Yeah, Jay, the IRS has been quite clear that they just want to educate themselves, and so they haven't stated an agenda in terms of these are the adjustments we plan to make on funds. They basically want to learn more about the industry and learn more about the funds. Having said that, of course, ECI is going to be the number one topic here and we're seeing that already – that the questions are focused on loan origination, whether or not there's a U.S. trader business, and those associated sub-issues.

Jay Freedman:

And Dilyana, you touched on some of the issues the states have been looking at. Anything to add?

Dilyana Antevil:

Yeah, on the ECI point is, you know, there may be no ECI for federal purposes under a 3D but there will be some for states that don't conform to 3Ds, so this is often an issue on the state side.

Another top issue that states are looking at is receipts sourcing. As I mentioned, the credit fund industry is young and often to source receipts, we need to first determine whether the fund qualifies as a financial institution. If it does, then it applies the rules that were written for traditional banking lenders. If it doesn't – this is where the issue has been – then it has to use the rules that are written for non-lending businesses, and often under these rules, interest could be excluded from the receipts factor all together, which is not reflective obviously of the funds activity if its main source of income as interest or capital gains from the sale of a loan along with fees. And so in those instances, when applying the rules does not produce the desired or the logical outcome, states are very aggressive in trying to, you know, apportion some of the income and impose tax on it.

Jay Freedman:

Great, and so let's talk a little bit about specifically about the IDRs that we've been seeing. Tom, what specifically have they been looking for and requesting and with respect to the IDRs?

Tom Greenaway:

Yeah, so Jay, this is, at least from the government's perspective, one of the strengths of using this campaign approach, because as you know, there are standard information document requests that really do get to the heart of the matter quite quickly that have been developed centrally. So the initial rounds of IDRs, of course, will act as for work papers and things like that from the tax return preparation, but almost immediately after that they're getting into questions around let us see your PPM, let us see what you told your investors around these issues including ECI, let us see your guidelines around ECI and avoiding ECI risk, any tax opinions, any tax memos. So again, getting right to the heart of the matter within one or two rounds of information document request.

Jay Freedman:

So these haven't necessarily been limited scope audits. These are let me see your work papers, let me see, let me see everything, right?

Tom Greenaway:

Yeah, that's right, Jay, and some of these audits – we've got to remember that the IRS audits a particular tax return for a particular tax year – so some of these campaign audits are popping up in the context of an audit of a 1065, so that's the, you know, all the information that's reported on the partnership return. Other audits are popping up in the context of a Form 8804, which is the withholding tax form for ECI income. Many of the funds that do not generate ECI, of course, do not file that form, so it's a little bit unusual to have an examination of an unfiled form, but we're seeing quite a few of those as well.

Jay Freedman:

Gotcha. Dilyana, from a state perspective?

Dilyana Antevil:

On the state side, states have been asking for data to support filing positions. For example, if it's a cost of performance jurisdiction, they will ask for, you know, payroll for both front office employees that are responsible directly for income generation, as well as back office employees. There could be other parties involved in the income generation. For example, investment committee, credit committee, that receive compensation and should be factored into the analysis. So they are trying to understand the facts, how the fund works. They want to be able to perform analytics based on the data taxpayers provide to them. They are often questioning inter-company borrowing and lending because not all funds use their own capital to make loans. So some of the IDRs, especially, you know, the second or third IDR that is sent to a taxpayer, are very detailed and focused on data and documentation of filing positions.

Jay Freedman:

And what's been the government's reaction to our responses to the IDRs? Has there been anything in particular, both federal and state, that have triggered, you know, more questions and another line of inquiry?

Tom Greenaway:

Well Jay, again as we've experienced together, the IRS has said from the beginning and said publicly that they want to get in and out of these cases, if it's not appropriate to continue them. I think it's still pretty early days. This campaign really only kicked off in earnest last fall, so and the IRS tends to work pretty slowly on these things. I am still optimistic that we are going to be able to assure the government that our clients are thoughtful, that our clients are careful, and our clients understand and apply these rules in the right way, and we've been given assurances that if that's the case, then the IRS will close the audit and move on. There certainly is a variety of practice out there in the market, and the name of the game here is to demonstrate to the IRS that our clients are doing, you know, organizing their operations in the right way to avoid ECI and towards some of the other tax issues that we've talked about on this call.

Jay Freedman:

And Tom, we've seen them ask for opinions, you know, guidelines, both internal and external, right? And I guess, you know, one of the issues you always have is the only worst thing, the only thing worse than not having an opinion or a guideline is having one and not following it.

Tom Greenaway:

Yeah, that's right Jay. I mean operations and execution – and Dilyana hit on this – I mean an auditor, you know a good auditor, will find instances where a taxpayer is not doing what they said they should be doing, and whether or not that's right or wrong, it's an opportunistic spot for the IRS to find themselves, so it's a good reminder to all of us that having a good plan and having a good set of guidelines is important, but operating and executing on those guidelines is absolutely essential.

Jay Freedman:

So what have we been seeing clients do to either help their cases or hurt their cases?

Tom Greenaway:

Yeah, so Jay, so Jay, certainly clients can help their cases as by having good clean organized data as Dilyana said, and being timely and efficient and professional and courteous with the IRS. Clients hurt their cases by hiding the ball, by delaying, by not engaging with the IRS. As I'd mentioned, this is largely viewed inside the IRS as an educational campaign for them. In giving the IRS the information as to how we thought about these issues with our clients, is important, and it will help our clients and, you know, I guess a collateral benefit for the IRS is that they're going to learn more and more about market practices and market differentiation. So those clients who are off market or who are not following their own guidelines are the ones who are going to find themselves in the most trouble.

Dilyana Antevil:

I wanted to address your question Jay from a different perspective in how clients can help themselves in an audit. I think one thing they could do better is be more proactive in approaching the states, especially where there is gray areas in the law. They could seek agreement upfront on certain filing positions, in the form of private letter rulings or petitions for alternative apportionment, so that there is an agreement with the state, which would help eliminate future controversy activity, minimize risk, and avoid large audit assessments. Another thing they could do better is to involve tax advisors upfront because it's easier to work with an auditor and guide them to reaching the correct conclusion than it is to reverse a conclusion that we don't think it's correct.

Tom Greenaway:

Dilyana that's an excellent point, and just to beat a dead horse here, the IRS is absolutely carefully coordinating these cases across the country and really across the globe, so it makes the most sense to have a provider and an advisor who has an equally broad perspective. And so a firm like KPMG, of course, is engaged with hundreds if not thousands of clients that have this issue, so we've got a really good perspective and we can bring that perspective to bear on behalf and for the benefit of our clients.

Jay Freedman:

Alright, awesome. Well, thank you guys. So we can see there's been a lot of activity around these issues and we certainly expect more to come.

On behalf of my colleagues at KPMG, I'd just like to thank everyone for listening and thank Tom and Dilyana for participating and giving their insights.

We'd love to hear from you, and if you have any questions about this topic or any other topic, please feel free to reach out to either me, Tom, Dilyana or any of your KPMG contacts. Again, thank you for listening and we hope to hear from you soon.

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