As banks shift lending toward larger corporations, fund managers are increasingly launching direct lending vehicles to finance small and medium-sized businesses. Funds seeking foreign or U.S. tax-exempt investors, however, must be carefully structured to minimize tax inefficiencies. Here are three approaches:

1. **Cayman-based “season and sell”**

   Establish a Cayman-based fund for non-U.S. investors and U.S. tax-exempt investors that owns and invests in both a U.S. corporation that originates loans in the U.S. and a Cayman corporation that may acquire some or all of such loans from the U.S. entity. Properly structured, it could avoid U.S. withholding tax on distributions from the Cayman corporation.

2. **U.S. corporation blocker**

   Use a U.S. corporation blocker, owned by the Cayman fund, through which the non-U.S. and tax-exempt investors invest. The Cayman fund funds a portion of its investment into the U.S. corporation blocker through debt. The U.S. blocker invests into the loan origination fund; while the U.S. blocker’s prorata share of the origination fund’s income would be subject to U.S. tax, the interest expense of the U.S. blocker could offset a portion of such income. If no investor in the Cayman fund (assuming it is taxed as a partnership) owns a 10% or greater indirect interest in the U.S. blocker, the interest income on the internal leverage should be exempt portfolio interest.

3. **Closed-end RIC**

   Structure a closed-end registered investment company (RIC) — taxed under Subchapter M of the Internal Revenue Code), which removes the need for any additional feeder funds or blockers. The structure does not generate ECI, and blocks UBTI for tax-exempt investors. It also generates dividends (sourced from interest on debt holdings) that are exempt from withholding. However, RICs require registration with the SEC and compliance with regulatory obligations of the Investment Company Act of 1940.

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