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A Report by UNITE HERE
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Private Equity's Irish Adventure: Has Tax Avoidance Put Limited Partners Outside Their Comfort Zone?

Oaktree Capital Management's funding of a Mars Capital Ireland, an "orphaned" Section 110 SPV, provides an example of the headline risk that tax avoidance may expose limited partners to.

Key Points

- In the wake of the financial crisis, the Irish government took steps to rescue its largest banks, including the creation of National Asset Management Agency (NAMA) which was tasked with acquiring property-related loans from distressed banks.
- The government's rescue measures – and subsequent mortgage portfolio sales to private investors – have received considerable criticism within the Irish media and political arena.
- Funds managed by Oaktree provided debt capital to Mars Capital Ireland, a special purpose vehicle that benefitted from Section 110 tax provisions, to fund the acquisition of residential mortgage loans from NAMA through the IBRC liquidation.
- Mars Capital Ireland is a bankruptcy remote vehicle own by three charitable trusts that are linked to the Matheson Foundation, the corporate philanthropy initiative of Matheson, a global corporate law firm with headquarters in Dublin.
- After deducting all interest expenses, Mars Capital Ireland reported a profit before tax margin of approximately 0.007% in 2015; the company reported taxes of €250.

NAMA creation and backlash

By 2009, the financial crisis had deflated Ireland's real estate bubble and pushed the country's major banks to the brink of collapse. In response, the Irish government passed the National Asset Management Agency Act (NAMA Act) in November 2009.[1] In February 2010, the European Commission granted approval for the establishment of the Agency.

As part of the rescue project, NAMA was tasked with acquiring property-related loans held by distressed banks.[2] The five designated participating institutions (PI's) were Allied Irish Banks, Bank of Ireland, Anglo Irish Bank, Irish Nationwide Building Society (INBS) and EBS Building Society.[3]

In its first Annual report, NAMA indicated that it paid approximately €30.2 billion[a] to acquire loans with a par value of €71.2 billion from the participating banks.[4] The portfolio of loans was then divided into two groups: The 180 largest debtors, with approximately €62 billion in loans, and the other 670 debtors accounting for remainder.[5] NAMA began managing the large debtor portfolio internally and the PI's took on the relationship management and loan administration duties for the portfolio of smaller debtors.[6] By the end of the acquisition phase, NAMA had paid approximately €31.8 billion to acquire loans with an aggregate par value of €74 billion and a market value of €26.2 billion.

The decision to rescue Ireland's banks received heavy criticism. In 2010, Fine Gael leader Enda Kenny described the creation of NAMA as a "perverse form of crony capitalism, or inverted socialism" and "the most expensive lie."[7] Stephen Donnelly, TD for Wicklow and East Carlow, has been a frequent critic of the program, highlighting issues such and the refusal to allow mortgage holders to bid on their own mortgages[8] and the tax avoidance structures employed by some large investors who purchased mortgage portfolios.[9]

Criticism does not appear to have faded over time. In early January 2017, RTÉ One aired "The Great Irish Sell Off," a 51-minute-long investigative documentary that explores the role that distressed debt buyers, such as Lone Star, Blackstone and Oaktree Capital Management (Oaktree) have played in the Irish economy in recent years.[10] An *Irish Times* columnist called the film "a stirring call to action."[11]

In the days following the airing of the RTE documentary, *The Irish Examiner* highlighted the case of Tara Robinson, a Limerick woman fighting eviction from The Stand Apartments Complex in where she has lived for the past seven years. Per the report, the mortgage for the complex was sold to Oaktree by NAMA in July 2016. Sova Properties, the mortgage holder prior to its transfer to NAMA in 2010, told the Irish Examiner that it was "directed by Oaktree to sell the apartment by vacant possession."[12]

The criticisms of NAMA and mortgage portfolio sales to private investors warrant attention. However, the remainder of this report will focus on the tax structures that Oaktree and other investors have used to avoid corporate taxes in Ireland.

IBRC liquidation

In January 2009, Anglo Irish Bank was nationalized with a capital injection of approximately €4 billion. This was followed by the €100 million recapitalization of INBS in 2010. By the end of 2010, the Irish government had invested approximately €34.7 billion into the two entities.[13]

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a Approximately 42% of par value.

In early 2011, the deposits held by Anglo Irish and INBS were transferred to other banks – Allied Irish Banks and Permanent TSB, respectively. In July 2011, the business of INBS was transferred to Anglo Irish and the entity that resulted from the merger became known as the Irish Bank Resolution Corporation (IBRC).[14]

The 2009 NAMA Act provided the Minister of Finance with the authority to issue guidelines, directions, regulations and orders to the Agency. At the end of March 2012, a Direction was made to the Board of NAMA to "adopt all reasonable measures to facilitate the short-term financing of IBRC."[15] About one year later, in February 2013, the IBRC Act was passed and the Minister of Finance made a Direction to NAMA that it make a bid for the assets of the IBRC.[16] Subsequently, Special Liquidators were appointed to the IBRC with a mandate to value and begin a sales process for the entity's loan portfolio.[17]

Oaktree appears to have gained exposure to Irish property loans through this liquidation process. In written response to a Dáil debate question about the IBRC Liquidation on May 14, 2014, Deputy Michael Noonan, the Minister of Finance, noted that 64% of the IBRC residential mortgage portfolio was sold to two entities, one of which was "Mars Capital Ireland Limited which is funded through funds managed by Oaktree Capital Management LP."[18]

Noonan's response indicated that the mortgages were not purchased by the funds managed by Oaktree. Rather, the funds managed by Oaktree provided funds to Mars Capital Ireland Limited, a section 110 special purchase vehicle.

Section 110 tax provisions

Section 110 of Ireland's Taxes Consolidation Act of 1997 provides for special treatment of qualifying special purpose vehicles (SPVs). To qualify, the company must meet certain conditions with regards tax residency, business activities, value of qualifying assets, arm's length transactions, and notify the Irish Revenue of its intention to be a qualifying company.[19]

Section 110 SPVs are subject to a 25% tax on accounting profits. However, the SPV is treated as trading company for tax purposes, meaning that a tax deduction is available for any interest incurred.[20] The ability to deduct any interest presents the opportunity for the SPV to earn minimal taxable income.

Per the accounts filed with Ireland's Companies Registration Office, Mars Capital Ireland Limited (Mars Capital Ireland) was incorporated in November 2013 as an SPV to acquire mortgage loans that were secured against properties in Ireland.[21]

Screen capture 1 On the RTE Documentary, "The Great Irish Sell-Off," Professor Ashoka Mody, former Head of Mission to Ireland for the IMF, discusses the use of Section 110 tax provisions by "vulture funds"

Having tax residency in Ireland requires that the effective management and control of the company is exercised in Ireland.[22] As of the June 30, 2015, Dublin-based TMF Administration Services Limited (TMF) served as Mars Capital Ireland's Company Secretary, Administrator, and Registered Office. The related-party transactions section of the annual report notes that four of the Mars Capital Ireland Directors also served as Directors of TMF during the same period. Additionally, no Mars Capital Director was a direct or indirect shareholder of the company.[23]

In May 2014, Mars Capital Ireland acquired loans and receivables for €154.7 million. This included 1,462 mortgages with an outstanding balance of €363 million, indicating that the portfolio was purchased at approximately 43% of par value.[24] Finance Minister Noonan indicated that the IBRC portfolio acquired consisted of residential mortgages.[25]

The purchases of the loans were funded by a Term Facility from Citibank and the issuance of secured Euro denominated Class A Notes and Class B Notes to "various investors." The Notes were issued at 100% par value of (approximately €80.3 million). They constitute a single class, but they are subordinated to the Term Facility.[26] As previously noted, written comments by Finance Minister Noonan stated that Mars Capital Ireland "is funded through funds managed by Oaktree Capital Management LP.".[27]

As of the year ended June 30, 2015, the interest expense on the Term Facility was 3-month LIBOR plus a fixed spread of 3.9%. The interest expense on the Notes was 10% per annum **plus any residual cash flows** from the loans and it is payable solely out of the cash flows received by the loans and receivables.[28] Total interest expense for the period was approximately €9.6 million.[29]

	30-Jun-15
Interest income	€ 14,118,769
Interest expense	€ (9,558,865)
Net interest income	€ 4,559,904
Administration expenses	€ (4,558,904)
Profit before tax	€ 1,000
Profit before tax margin	0.007%
Corporation tax	€ (250)
After tax profit	€ 750

Figure 1 Source: Mars Capital Ireland Annual Report for the year ended June 30, 2015; estimate calculation by UNITE HERE

Mars Capital Ireland recorded administrative expenses of approximately €4.6 million in 2015.[30] The company has no employees and outsources services to the Administrator, TMF. The largest administrative fee, approximately €2.5 million, was paid to the UK-based Mars Capital Finance Limited, which was retained as the Master Servicer for the portfolio.

After deducting all interest expenses and administration expenses, Mars Capital Ireland recorded profit before tax of €1,000 on interest income of approximately €14.1 million, an estimated margin of approximately 0.007% for the period ended June 30, 2015 (Figure 1).

Figure 2 (below) presents a visual interpretation of the cash flows between the loan portfolio, Mars Capital Ireland, the Term Facility, and the Notes:

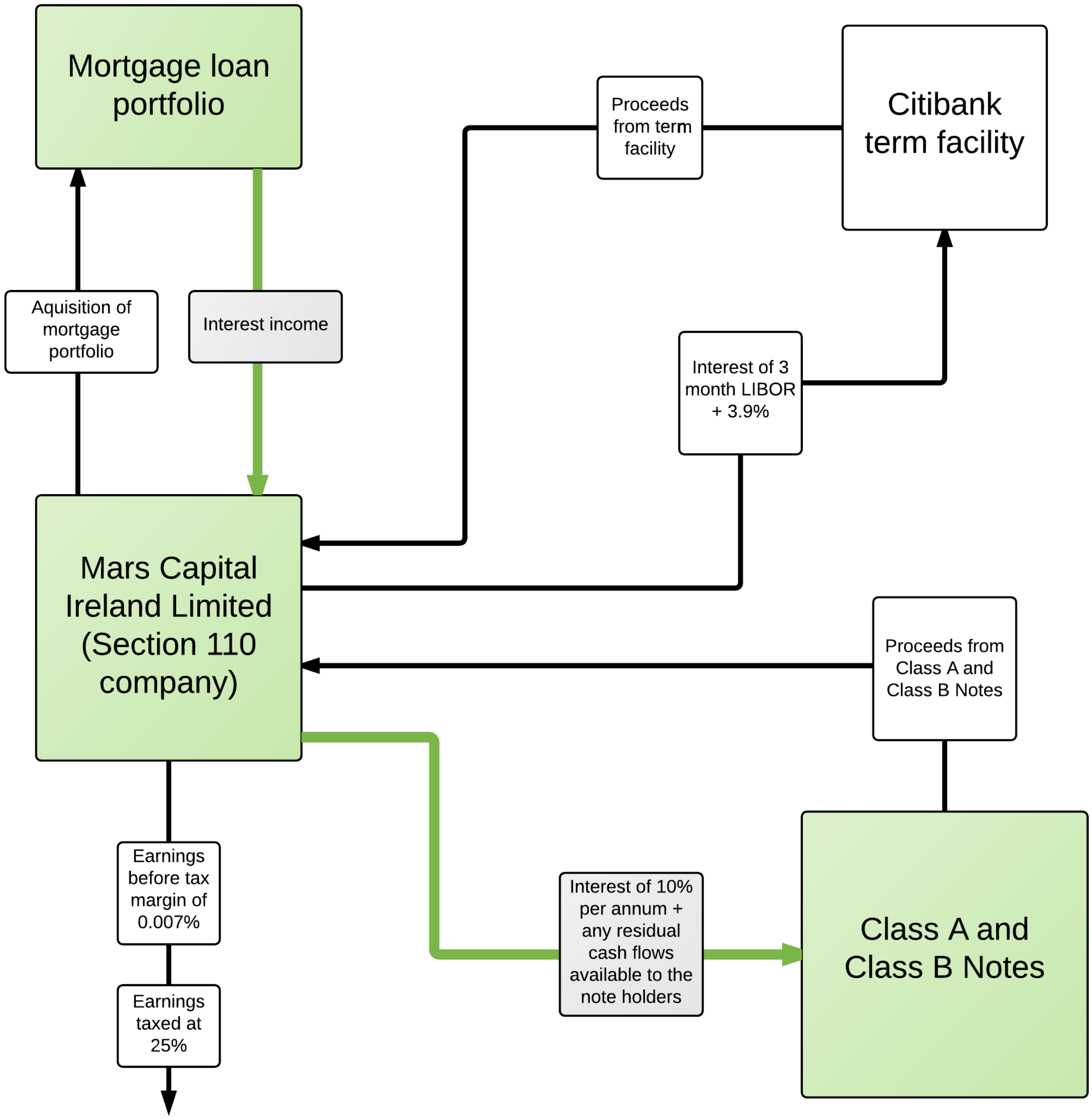

Figure 2 Sources: UNITE HERE analysis of Mars Capital Ireland Annual Report and comments by Finance Minister Noonan

The Irish press has since reported on another mortgage loan portfolio sale that appears to be connected to Oaktree. In June 2016, Reuters reported that Oaktree beat Cerberus and Lone Star to be selected by NAMA as the preferred bidder on the "Project Ruby and Project Emerald portfolios," said to have a combine par value of approximately €4.7 billion.[31] However, it's not clear if Mars Ireland, or another Section 110 company, was used in structuring the acquisition.

On September 6, 2016, Finance Minister Noonan proposed amending Section 110 of the Taxes Consolidation Act of 1997 to target "the possible use of aggressive tax practices by some section 110 companies to avoid paying tax on Irish property transactions." Although slated to be enacted later, the changes were applied on the day of the announcement.[32] However, Stephen Donnelly TD has argued that existing property loan portfolios could be converted into compliant asset classes that could continue to take advantage of Section 110 tax provisions.[33]

'Orphaning' and charitable trusts

Section 110 Special Purpose Vehicles (SPVs) are often structured as bankruptcy remote "orphan" companies with an independent entity as the beneficial shareholder, often a charitable trust.[34]

As of the end of fiscal 2015, Mars Capital Ireland had issued three shares: One each to the BADB Charitable Trust Ltd, the Eurydice Charitable Trust Ltd, and the MEDB Charitable Trust Ltd.[35] The three charitable trusts are linked to the Matheson Foundation, the corporate philanthropy initiative of Matheson, a global corporate law firm with headquarters in Dublin. The law firm also serves as Solicitor for Mars Capital Ireland.[36] Matheson states that the aims of the Foundation are to "help children in Ireland fulfil their potential" and to "encourage corporate philanthropy in Ireland."[37]

Figure 3 represents the flow of accounting earnings to the shareholders' equity as described in Mars Capital Ireland's annual report for 2015. As previously noted, the company reported profit before tax of €1,000 on interest income of approximately €14.1 million, a margin of about .007%.[38]

It does not appear that Mars Capital Ireland distributed any cash to the charitable trusts during fiscal 2015. Neither the Statement of Cash Flows[39] nor the Statement of Changes in Equity reported any dividends

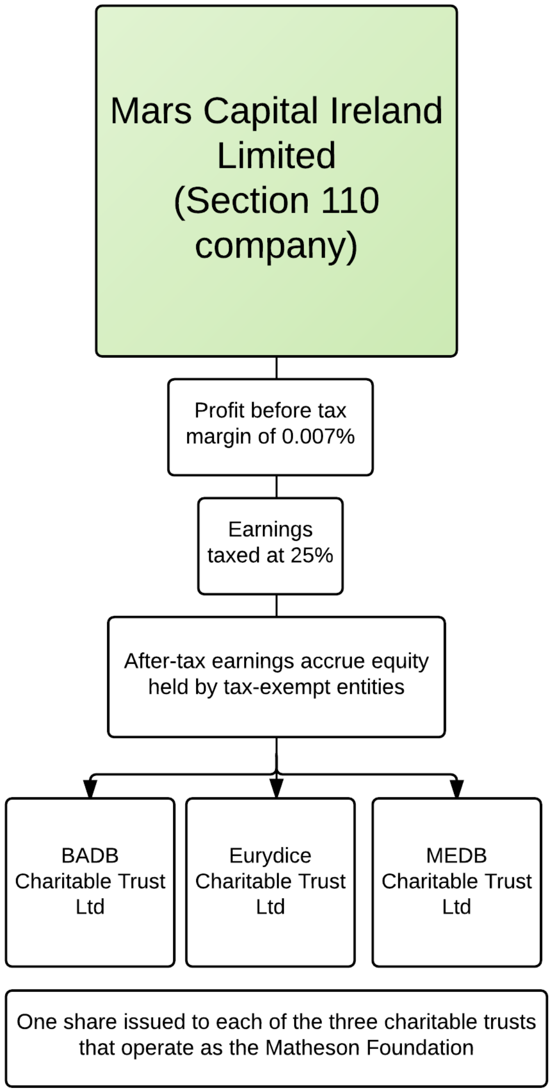

Figure 3 Source: UNITE HERE analysis of Mars Capital Ireland Annual Report; Matheson website

paid during the year.[40] After taxes, €750 in retained earnings accrued to the equity owned by the three charitable trusts.[41] In contrast to the €750 in retained earnings, the company paid approximately €8.9 million[b] in interest and redeemed principal to the Noteholders during the year (figure 4.)

Matheson has been criticized for the scope of its role in facilitating the use its charitable trusts in structured finance deals.[42] *The Irish Times* reported that the three charitable trusts recorded gross income of approximately €681,000 in 2015, which came from a roughly equal mix of donations and "service fees."[43] The report speculated that the "service fees" are paid by hedge funds and other firms that benefit from the Section 110 tax provisions. If "service fees" were paid by Mars Capital Ireland, they do not appear to be explicitly disclosed in the annual report.

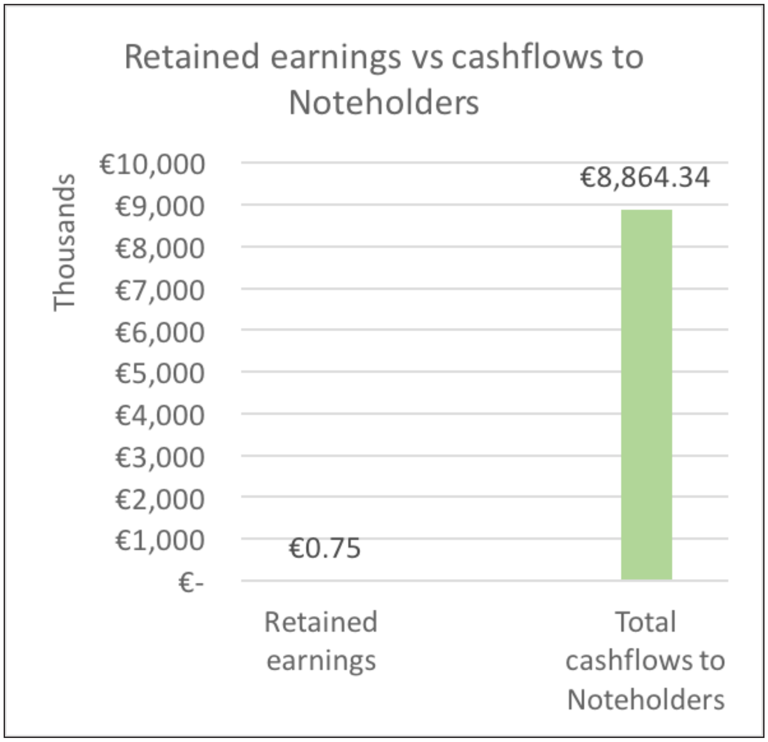

Figure 4 Source: UNITE HERE analysis of Mars Capital Ireland Annual Report

In June 2016, after Stephen Donnelly TD raised the issue of Oaktree and Mars Capital Ireland in the Dáil, Tánaiste Frances Fitzgerald announced that she would ask the charities regulator to review the issue.[44] Matheson continued to receive criticism in late 2016 as two of the charities named as partners of the Matheson Foundation denied having received any donations from the charitable trusts.[45]

Questions for limited partners

- Were limited partners informed of the potential use of section 110 SPVs to gain exposure to residential mortgages in Ireland?
- Does Oaktree have formal policies for the assessment of risks related to tax avoidance measures? If so, how are the risks reported to limited partners?

b Interest paid on Notes of €2,883.849 and redemption of Notes of €5,980,487.

Disclosures

UNITE HERE is a labor union that represents working people across Canada and the United States in the hospitality industry. Through its PE Closer Look blog, the UNITE HERE publishes reports that often concern private fund managers, including Oaktree Capital Management, that have been asset owners in this industry.

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