CLO Investments: Navigating Tax Challenges in a Resurging Market

Balancing Between Debt and Equity Tranches; Applying FATCA, PFIC, CFC and NII Regulations; Handling Acquisition Indebtedness

WEDNESDAY, NOVEMBER 5, 2014
1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today’s faculty features:

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Part I: Overview of CLOs and relevant non-tax regulatory issues

CLO Investments: Navigating Tax Challenges in a Resurging Market

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What is a CLO?
Overview

Typical structure of a CLO

Source: Oxford Lane Capital Corp. Pro Sup (Nov. 7, 2012)
Overview

Differences Among Tranches of CLOs

- CLOs issue several classes of liabilities, or tranches, with each tranche varying in level of seniority, risk and return.

- Senior tranches are well-insulated from losses due to overcollateralization (value in the underlying pool of loans exceeding CLO liabilities), excess interest proceeds (interest cash flow from the underlying loans greater than CLO liabilities debt service) and diversion triggers (if loan performance deteriorates, CLO equity cash flows are redirected to retire senior tranches).

- Senior CLO tranches carry investment-grade ratings. Equity tranches, at the bottom of the capital structure, receive excess proceeds once debt tranches have been paid off.
Why is it relevant now?
Overview

CLO issuance has returned to pre-recession levels.

Roaring Back

Amid a revival in sales of new collateralized loan obligations and new rules affecting ownership of the debt, banks are trying to rustle up interest from new buyers.

Issuance, through April of each year

<table>
<thead>
<tr>
<th>Year</th>
<th>2001</th>
<th>2005</th>
<th>2010</th>
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<tr>
<td></td>
<td>$40 billion</td>
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Yield premiums on AAA CLO securities*

<table>
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<th>Year</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
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<td></td>
<td>12%</td>
<td>14%</td>
<td>16%</td>
<td>18%</td>
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</table>

April: 149 percentage points

Pipeline of CLOs expected to come to market

<table>
<thead>
<tr>
<th>Year</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$20 billion</td>
<td>$16 billion</td>
</tr>
</tbody>
</table>

CLO holdings

- $300B: CLOs outstanding in the U.S.
- $195B: About 65% of the $300 billion is AAA notes
- $136B: Banks globally own about 70% of the AAA notes

*Yield spread over 3-month Libor, excludes middle market CLOs
Sources: S&P Capital IQ Leveraged Commentary & Data (issuance, pipeline); Thomson Reuters (yield); Loan Syndications and Trading Association (holdings)
Overview

Pension funds, hedge funds, and other asset managers make up an increasing share of the investor base.

Source: LSTA
But regulatory restrictions loom in 2017:

• The Volcker Rule will restrict banks from owning certain types of CLOs.

• New risk retention rules will require that the CLO manager must retain not less than 5% of the credit risk of the assets collateralizing the securities.
Overview

ERISA Plan Assets and CLOs

• Is the relevant tranche classified as debt for ERISA purposes? At what level of certainty?
• If not, is any class owned 25% or more by ERISA investors?
Part II: Overview of US Federal Tax Issues
Presented by CLOs

CLO Investments: Navigating Tax Challenges in a Resurging Market
Taxes on the CLO Issuer

- The only source of cash of the CLO Issuer is payments on its underlying assets and gain from the disposition of those assets.
- The CLO Issuer needs those cash flows to make payments on its own securities.
- It is therefore critical that cash can move through the system without suffering material tax leakage.
- Tax leakage could arise from the imposition of gross basis withholding tax on payments to the CLO Issuer.
- Tax leakage could also arise as a result of the imposition of net income tax on the CLO Issuer.
- It could also arise if the CLO Issuer is required to make gross up payments to investors or other parties (e.g. hedge counterparties, if any).
- Deals typically provide for a “tax redemption” if the CLO Issuer suffers tax leakage in excess of certain thresholds
Cash Movement Through a CLO

- Investors
  - Class A Notes
  - Class B Notes
  - Class C Notes
  - Class D Notes
- Administrative Expenses
- CLO Issuer
  - Collateral Obligations
  - Collateral Obligations
  - Collateral Obligations
  - Collateral Obligations
- Subordinated Notes
- Management Fee
- cash
Taxes on the Noteholders

- A further level of tax leakage could arise as a result of withholding taxes on payments to the Noteholders.
- In addition, Noteholders typically are subject to net basis tax on the income they receive or accrue on their CLO securities.
- How the Noteholders will be taxed depends upon different factors:
  - Are they US persons or non-US persons?
  - Are they tax-exempt entities?
  - Do they hold debt or equity securities?
  - Are debt classes issued with original issue discount?
  - Is the Issuer a passive foreign investment company (PFIC) or a controlled foreign corporation (CFC)?
  - If the Issuer is a PFIC, does an equity holder make a qualified electing fund (QEF) election?
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Part III: Exposure to US Federal Net Income Tax

CLO Investments: Navigating Tax Challenges in a Resurging Market
Exposure to US Federal Net Income Tax

• Most CLOs that focus on investments in US loans are structured as Cayman Islands limited companies that are treated as corporations for US federal tax purposes.

• European CLOs are typically structured as corporations based in Ireland or the Netherlands and are also treated as corporations for US federal tax purposes.

• Non-US corporations generally are not subject to US federal net income tax.

• However, if an offshore corporate CLO Issuer is engaged in a US trade or business, it will be subject to US federal net basis income tax on its income effectively connected with its US trade or business and will also be subject to the branch profits tax.
  – State and local net income tax could also be imposed.
  – Imposition of such taxes would have a materially adverse effect on the CLO Issuer’s cash flow.
  – It would also likely result in a tax redemption.

• Because of the serious consequences the imposition of US federal net income tax would have for investors in a CLO, the rating agencies require that tax counsel provide an opinion that the CLO Issuer will not be engaged in a US trade or business for US federal income tax purposes.
Exposure to US Federal Net Income Tax

• In order to avoid the imposition of US federal net income tax and to obtain a “US trade or business” opinion, corporate CLO Issuers take pains to avoid becoming engaged in a US trade or business.

• They seek to structure their activities so as to fall within the self-trading safe harbor under section 864 (Treas. Reg. section 1.864-2(c)(2)).

• They typically operate under detailed guidelines that seek to ensure that the CLO Issuer is not engaged in loan origination or otherwise treated as conducting a lending or other financial business.
  – Sensitive areas include forward purchase commitments, delayed draw and revolving loans and letters of credit.
  – Typically there are also restrictions on ownership of certain types of equity securities.
Exposure to US Federal Net Income Tax – Blocker Subsidiaries

- A CLO Issuer may receive equity securities in an operating partnership or other entity that would result in attribution of a US trade of business to the CLO Issuer in a workout of a collateral obligation.
- Moreover, activities in connection with the workout of a distressed collateral obligation could cause the CLO Issuer to become engaged in a US trade or business.
- To mitigate the risk that such an asset or activity causes the CLO as a whole to be engaged in a US trade or business, a CLO Issuer is typically permitted to transfer the asset in question to a blocker subsidiary.
- A blocker subsidiary is a US or non-US entity treated as a corporation for US federal income tax purposes.
- It will be subject to US net income tax and file US tax returns.
- The rating agencies impose detailed requirements relating to the structure and governance of blocker subsidiaries.
- Assets typically can be transferred from the blocker subsidiary back to the CLO Issuer if tax counsel can provide an opinion that holding the asset directly will not cause the Issuer to be engaged in a US trade or business.
Exposure to US Federal Net Income Tax – Partnership CLOs

• In some deals, collateral managers do not wish to be constrained by detailed US trade or business guidelines
  – For example, a manager may wish to engage in loan origination,
  – Or it may wish to acquire affiliate originated loans under circumstances in which there is a risk that origination would be attributed to the CLO Issuer.
• These kinds of CLOs are structured as entities that are transparent for US federal income tax purposes.
• It then becomes important to ensure that the CLO Issuer is not a publicly traded partnership, which would be treated as a corporation for US federal tax purposes.
  – Given origination activity, it is unclear whether the CLO Issuer would have “qualifying income” under section 7704.
  – Thus, the CLO Issuer will seek to avoid treatment as a publicly traded partnership by imposing transfer restrictions on the classes of notes treated as equity or with respect to which only a “should” level or no “debt for tax opinion” is given.
  – It is advisable to ensure that notes subject to such transfer restrictions are in certificated form, so as to allow for policing of the transfer restrictions.
Exposure to US Federal Net Income Tax – Partnership CLOs

• If the CLO Issuer is a partnership that is engaged in a US trade or business, it would be required to withhold on income allocable to foreign partners under section 1446.

• Since the obligation to withhold and remit tax under section 1446 would be imposed on the CLO Issuer and thus would cut into the cash waterfall in the deal, it is important to ensure that no foreign persons are deemed partners in the CLO Issuer.

• Again, this is done by limiting holders of classes of notes treated as equity or with respect to which only a “should” level or no “debt for tax opinion” is given to US persons.

• If there is only a single holder of the CLO’s tax equity, the CLO Issuer typically takes the position that it is a disregarded entity and is not subject to withholding obligations under section 1446.
Part IV: Exposure to US Withholding Tax - FATCA and non-FATCA

CLO Investments: Navigating Tax Challenges in a Resurging Market
Exposure to US Federal Gross Basis Income Tax (Other than FATCA)

• If payments on underlying loans or short-term investments ("eligible investments") are subject to withholding tax, the CLO Issuer will suffer a cash flow shortfall and may be subject to a tax redemption.

• The primary source of income for a CLO Issuer is interest income on loans it holds ("collateral obligations").

• US source interest income on these types of loans is generally exempt from US withholding tax under the portfolio interest exemption.
  – Typically collateral must be in registered form to ensure eligibility for the portfolio interest exemption.

• Eligible investments usually qualify for the exemption for short-term debt.

• However, US withholding tax may be imposed on commitment fees received with respect to delayed draw or revolving loans and similar fees.

• Deals that permit synthetic letters of credit or letter of credit reimbursement obligations often provide for a reserve account in case the agent bank does not withhold on fees received on such assets.

• US withholding tax generally will apply to equity securities of US issuers the CLO Issuer receives as a result of workouts.
FATCA – Background and Purpose

• FATCA targets offshore tax evasion by US persons – broadly, the hiding of money in offshore accounts.
• It does so by co-opting overseas persons, predominantly financial institutions (broadly defined), as information-gathering agents of the IRS.
• These persons are effectively forced, through the threat of withholding tax, to gather and report information about “accounts” (broadly defined) they maintain for US persons or certain US-owned entities.
  - The IRS can then monitor whether those US account holders are paying the US tax they should be paying in respect of their offshore assets.
• The rules for financial institutions are much more burdensome than for non-financial entities since financial institutions have greater potential to facilitate tax evasion.
FATCA – Persons Potentially Subject to Withholding

• FATCA withholding can apply to payments to foreign financial institutions ("FFIs").
• FFIs include
  – Custodial Institutions (≥20% of institution’s gross income derives from holding financial assets for the account of others and related financial services)
  – Depository Institutions (institution accepts deposits in ordinary course of banking or similar business)
  – Investment Entities (itself broadly defined to include investment managers and securities dealers, professionally managed investment funds and other fund vehicles)
  – Certain insurance companies
  – Certain holding companies and treasury centers.
• FATCA withholding can also apply to payments to non-financial foreign entities ("NFFEs").
• A CLO Issuer is a foreign financial institutions for purposes of FATCA.
FATCA – Who Is Required to Withhold

- The IRS can generally enforce withholding tax obligations against US-based persons and others who have entered agreements with it.

- FATCA imposes withholding obligation on:
  - “Withholding agents” (e.g., a US borrower) who may be required under FATCA to withhold tax at 30% when paying interest (or other amounts) to certain FFIs and NFFEs.
  - In addition, FFIs who enter into FATCA agreements with the IRS (“participating FFIs”) may be required to withhold on payments that they make to FFIs that do not comply and certain other persons (“passthru withholding”).
    - FFIs would subject themselves to this obligation in order to avoid the imposition of FATCA withholding on payments to them.
  - Thus, a CLO Issuer could suffer FATCA withholding on payments made by US borrowers and, if it becomes a participating FFI to avoid such withholding tax, it may itself be required to withhold under FATCA.
FATCA Withholding

- As of July 1, 2014 FATCA withholding applies to US source income payments (e.g. interest and fees) on:
  - Any loan with a US borrower
  - Any loan otherwise giving rise to US source payments (e.g. where borrower is engaged in US trade or business or lenders look to credit of US guarantor).
  - Thus, FATCA withholding potentially applies to most income of a US-focused CLO Issuer.
- Starting January 1, 2017 FATCA will apply to gross proceeds from disposition of US debt and equity securities (including repayment of loan principal).
- Starting no earlier than January 1, 2017 FATCA withholding will apply to “foreign passthru payments”.
  - Scope remains uncertain but may encompass interest and principal paid by non-US borrowers.
- No FATCA withholding if a loan is grandfathered.
  - July 1, 2014 for loans giving rise to US source payments – so withholding potentially applies to all new bank loans to US obligors
  - Later date for loans that can only give rise to “foreign passthru payments”
  - Loss of grandfathering if there is a “significant modification” after grandfathering date
- Thus, US assets held by a CLO Issuer are potentially subject to FATCA withholding unless they were issued before July 1, 2014 (and are not restructured and deemed reissued thereafter).
Compliance with FATCA

• FATCA withholding is not imposed on payments to compliant entities.
• Compliance is potentially quite burdensome for FFIs, since those are the entities with the greatest potential to facilitate tax evasion by US taxpayers.
• An FFI, such as a CLO Issuer, has a number of options to achieve FATCA compliance:
  • It can enter into an agreement with the IRS to become a “participating FFI”. This requires gathering extensive information about its noteholders and delivering that information to the IRS, potentially closing certain “accounts” and potentially withholding on payments to certain types of account holders.
    – Signing up to an FFI agreement with the IRS raises many issues relating to compliance with local bank secrecy and data privacy rules and local law limitations on withholding and account closure.
  • The CLO Issuer can instead seek to comply with an intergovernmental agreement between the United States and its home jurisdiction intended to facilitate compliance with FATCA and overcome local law obstacles.
    – This still requires gathering extensive information about noteholders and delivering that information to local tax authorities who will share it with the IRS.
• Certain older CLOs may be able to qualify as “deemed compliant” based on a special transition rule in Treasury regulations for so-called “Limited Life Debt Investment Entities”.

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FATCA – Intergovernmental Agreements

• Many non-US jurisdictions have signed or are close to signing intergovernmental agreements (“IGAs”) with the United States.
• There are two types of IGAs, one requiring provision of information to local tax authorities (Model 1 IGAs) and the other permitting agreements with the IRS (Model 2 IGAs).
• All the typical CLO jurisdictions, including the Cayman Islands, Ireland, and the Netherlands have signed Model 1 IGAs with the United States.
• These jurisdictions have also adopted local implementing rules.
• FFIs complying with local IGA-based regimes generally will not be subject to FATCA withholding on payments they receive.
• They also generally enjoy exemptions from FATCA withholding on payments they make.
• So far IGAs do not require withholding on “foreign passthru payments”.
• Cayman administrators now routinely register CLO Issuers with the IRS and take steps to ensure that a CLO Issuer reports required information to the Cayman Islands Tax Information Authority.
  – Administrators in other jurisdictions are doing the same.
• CLO Issuers also provide IRS Form W-8BEN-E to withholding agents to certify that they are FATCA compliant.
• Indentures also typically permit supplemental indentures without the consent of noteholders to make amendments necessary to achieve compliance with FATCA.
FATCA - Documentation

• The deal documents for a CLO need to include provisions to ensure that the CLO Issuer can comply with FATCA.

• Typically the indenture will impose a requirement on noteholders to provide to the CLO Issuer and its agents FATCA-related tax forms and any other information the CLO Issuer is required to report either to the IRS or its local tax authorities pursuant to an IGA.

• The indenture also requires noteholders to acknowledge that any information they provide will be shared with tax authorities in this way.

• The indenture typically permits the CLO Issuer to force a noteholder that fails to satisfy its information obligations or that otherwise prevents the CLO Issuer from complying with FATCA to sell its notes or to sell the notes on behalf of that noteholder.

• Some CLOs also require a noteholder to indemnify the CLO Issuer and other noteholders for damages suffered as a result of the noteholder causing the Issuer not to achieve FATCA compliance.
Withholding by the CLO Issuer

- Tax leakage on the cash flowing from the underlying borrowers of the CLO’s collateral obligations through the CLO Issuer and into the hands of the noteholders can also occur at the level of payments by the CLO Issuer.
- Unless a CLO Issuer is engaged in a US trade or business, interest it pays is not subject to US (non-FATCA) withholding tax.
- Provided the CLO Issuer is based in an IGA jurisdiction, it also generally will not be required to withhold under FATCA.
- If withholding ever were imposed on payments to noteholders, a CLO Issuer generally would not be required to make gross up payments to holders of its notes.
- A CLO Issuer might be required to make gross up payments to a hedge counterparty (if it were to enter into a hedge agreement) and any such gross up payments typically would factor into the determination of whether a tax redemption has been triggered.
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Part V: Tax Characterization of a CLO Issuer’s Notes

CLO Investments: Navigating Tax Challenges in a Resurging Market
## Example of CLO Capital Structure

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<thead>
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<th>Class</th>
<th>Rating</th>
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<tbody>
<tr>
<td>Class A Notes</td>
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<tr>
<td>Class B Notes</td>
<td>AA</td>
</tr>
<tr>
<td>Class C Notes</td>
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<tr>
<td>Class E Notes</td>
<td>BB</td>
</tr>
<tr>
<td>Class F Notes</td>
<td>B</td>
</tr>
<tr>
<td>Subordinated Notes</td>
<td>Unrated</td>
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</tbody>
</table>
Are the Notes Debt or Equity?

- The US tax consequences to a noteholder depend upon whether the notes it owns are debt or equity for US federal income tax purposes.
- In a CLO transaction the cash flow from a pool of assets is carved up to support different tranches of securities.
- The most senior tranche is rated AAA, below that there are other investment grade tranches, followed by one or more below investment grade tranches and finally an unrated tranche.
- The unrated tranche is typically in the form of subordinated notes and is treated as equity for US federal income tax purposes.
- Tax counsel in a CLO generally provides opinions that certain classes of rated notes “will be” or “should be” treated as debt for US federal income tax purposes.
- Classes of rated notes that receive only a “should” level opinion or no debt-for-tax opinion at all are at greater risk of being recharacterized as equity.
- Typically notes that receive only a “should” level opinion or no debt-for-tax opinion at all are ERISA restricted.
Debt/Equity

• Tax counsel in CLO transactions considers the usual debt/equity factors in opining whether a class of notes will or should be debt for US federal income tax purposes, including
  – Term
  – Existence of creditor’s remedies
  – Interest rate
  – Position in the capital structure
  – Likelihood of repayment
  – Debt to equity ratio
  – Overlapping ownership between debt and equity classes
  – Designation of the instrument as debt or equity

• As a rule of thumb, investment grade classes of notes usually receive a “will” level debt for tax opinion

• Tranches in the B range generally do not receive any debt for tax opinions
Part VI: Equity investments in foreign issuers (PFICs and CFCs)

CLO Investments: Navigating Tax Challenges in a Resurging Market
What is a PFIC?
CLO Equity Tranche: PFICs

Determination of PFIC Status: Asset/Income Test

• A foreign corporation is a PFIC if the foreign corporation has
  – Passive income that is at least 75% of gross income in any tax year; or
  – Passive assets that represent at least 50% of its total assets in any tax year.
CLO Equity Tranche: PFICs

• Passive income includes, inter alia:
  – Dividends, interest, royalties, rents, and annuities.
  – Net gain from the sale or exchange of property that gives rise to the above categories of income, other than property that gives rise to active rents or royalties from unrelated persons or income that is not foreign personal holding income.
  – Whether or not an asset is “passive” is determined by whether or not the asset produces passive income or is held for the production of passive income.
CLO Equity Tranche: PFICs

• § 1297(c) requires one to look through to the income/assets of any lower tier corporations that are at least 25% owned (by value) by a foreign corporation, and attributes the proportionate share of the income/assets of the lower tier corporation to the upper tier corporation to determine the PFIC status of the upper tier corporation.
CLO Equity Tranche: PFICs

• § 1298(a) contains special rules for attribution of ownership of PFIC stock to the first US person in an ownership chain.

• Any person who owns 50% or more of the value of a non-PFIC foreign corporation (or any % of a PFIC) is attributed a proportional percentage of ownership of any stock owned by that foreign corporation.

• Stock owned directly or indirectly by partnerships, trusts, or estates is considered to be owned proportionately by partners and beneficiaries.
Tax treatment of PFIC owners
CLO Equity Tranche: PFICs

- Absent a QEF election, a PFIC shareholder is subject to a “deferred tax amount” on PFIC “excess distributions,” which are certain distributions and gain on the disposition of PFICs.
- An excess distribution is the amount by which the shareholder’s current year distribution exceeds 125% of the average distributions received by the shareholder for the three preceding years.
- The deferred tax is calculated at the highest rate in effect for each prior PFIC year under § 1 or 11 (whichever applicable); and added to the shareholder’s tax liability for the current year, with interest due for the period from the due date of the return for the prior PFIC year through the due date for the current year.
A PFIC shareholder may elect under § 1295 to treat the PFIC as a “Qualified Electing Fund” thereby subjecting the shareholder to the QEF rules in § 1293.

A QEF shareholder must receive an annual information statement from the PFIC in order to make a QEF election or report a QEF inclusion for a taxable year.

A QEF shareholder is taxed annually on its pro rata share of the PFIC’s ordinary earnings and net capital gain, regardless of whether or not any amounts are distributed to the shareholder. The pro rata share of the ordinary earnings is included in the shareholder’s income as ordinary income, and the pro rata share of the capital gains is included as long term capital gain.

Amounts distributed from the PFIC to a QEF shareholder that previously have been included in income (“PTI”) under the QEF rules are not taxed again when distributed, and are treated as amounts that are not a dividend except that they reduce the PFIC’s earnings and profits.

The QEF shareholder’s basis in its PFIC stock is increased by the amount of any QEF inclusions and decreased by the amount of any distributions excluded from income as PTI.
CLO Equity Tranche: PFICs

Information Reporting: Temp. Reg. §1.1298-1T

• PFIC shareholders must report their ownership of a PFIC on Form 8621.

• Investors who hold PFIC stock indirectly through a domestic entity do not need to file Form 8621 if the domestic entity files the form, unless the investor receives an “excess distribution.”

• PFICs reported on Form 8621 do not need to be reported on Form 8938
What if the foreign issuer is a CFC?
CLO Equity Tranche: CFCs

- A CFC is defined as a foreign corporation in which, on any day of its tax year, greater than 50% of the voting power or value of its stock is owned by 10% or greater US Shareholders.
- A US Shareholder is a US person who owns at least 10% of the foreign corporation’s stock, by voting power.
- US Shareholder is required to recognize ordinary income in an amount equal to such shareholder’s pro rata share of Subpart F income of the CFC.
- Subpart F income includes, inter alia, interest and gains from the sale of securities.
- Later distributions of previously tax earnings and profits are excluded from tax.
CLO Equity Tranche: CFCs

• A foreign corporation can be both a CFC and a PFIC. § 1297(d) provides that a corporation that is both a CFC and a PFIC will be treated as a CFC with respect to any shareholders that are US shareholders of the corporation for CFC purposes and subject to tax under Subpart F.

• Because the CFC/PFIC overlap rule only applies to “US shareholders”, a foreign corporation may be a CFC with respect to some shareholders and a PFIC with respect to others.
CLO Equity Tranche: Subordinated Tranches

Query whether very junior subordinated tranches could be treated as equity for tax purposes, in which case:

• Such notes could be treated as voting securities and the holders of such notes would be treated as US Shareholders under Subpart F
• Noteholders should consider protective QEF elections for very junior tranches
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Part VII: Net Investment Income Tax Issues

CLO Investments: Navigating Tax Challenges in a Resurging Market
What is the Net Investment Income Tax?

3.8% tax imposed on net investment income (NII)
• For individuals (not trusts or estates), NIIT is 3.8% of lesser of
  – NII
  – Excess of modified adjusted gross income (MAGI) over
    • $200,000 if single
    • $250,000 if married, filing jointly ($125,000 if married, filing separately)
    • Thresholds not indexed for inflation
• MAGI is generally defined as adjusted gross income (AGI) plus net foreign earned income exclusion and certain adjustments related to CFCs and PFICs
What is Net Investment Income?

• Three categories of income
  – income not derived in ordinary course of business such as interest, dividends, rents, royalties and annuities
  – other gross income derived from a trade or business that is a passive activity (within meaning of §469) or trading in financial instruments or commodities (as defined in §475(e)(2))
  – net gains from disposition of property (other than property held in a trade or business that is not a passive activity or trading business)
How are Subpart F and QEF inclusions treated for NIIT?

Default rule:

• Subpart F inclusions and QEF inclusions are not subject to NIIT when they are included in income

• Instead, NIIT applies to these amounts when the taxpayer actually receives the dividend payments attributable to these amounts.
How are Subpart F and QEF inclusions treated for NIIT?

Special “G” election:

• A taxpayer may make an election to include its share of subpart F and QEF income inclusions as NII in the same tax year that such income is included for regular income tax purposes.
• The election can be made by intermediate passthru entities holding the direct interest in CFCs or PFICs.
• In addition, the election can be made on an entity by entity basis.
How is the election made?

- Check box on Form 8960 filed with the taxpayer’s return for the tax year in which the election is made.
- Statement attached to tax return identifying the PFICs and CFCs to which the election applies.
- Election must be made in the first tax year in which Subpart F income or a QEF inclusion from the applicable CFC or PFIC is included.
Part VIII: Tax Exempts, UBTI and UDFI

CLO Investments: Navigating Tax Challenges in a Resurging Market
Tax Exempt Issues: UBTI and UDFI

• Tax-exempt organizations (TEOs) are subject to a tax on their unrelated business income (UBTI).
• Passive investment income, including rents from real property, are generally exempt from this tax unless the property generating the passive income is debt-financed (UDFI).
• Property is “debt-financed” when “acquisition indebtedness” is incurred to acquire or improve it.
Tax Exempt Issues: UBTI and UDFI

• If a TEO’s share of partnership income is derived from partnership property that is debt-financed, the income from the property is taxable as debt-financed income.

• The taxable amount of UDFI is calculated as a percentage of income derived from “debt-financed property” equal to the “average acquisition indebtedness” for the taxable year over the average amount of the adjusted basis for the taxable year.
What are the potential sources of UDFI in a CLO investment?

• TEO incurs acquisition indebtedness directly to finance a CLO investment
• TEO invests in a pass-thru entity that incurs acquisition indebtedness to finance a CLO investment
• TEO invests (directly or through a pass-thru entity) in a partnership CLO issuer, which incurs acquisition indebtedness to purchase the underlying loans.
Tax Exempt Issues: UBTI and UDFI

What are the options for dealing with UDFI?

• Many fund agreements contain limitations on the fund’s ability to incur UDFI

• Use of a foreign blocker could reduce or eliminate UDFI with no tax cost if:
  – The foreign blocker does not have any US source income on which it must pay US tax
  – The foreign blocker is not subject to withholding tax in its jurisdiction of formation
Part IX: Summary and Questions

CLO Investments: Navigating Tax Challenges in a Resurging Market
Summary

- A key issue in a CLO transaction is to ensure that cash moves through the structure with minimal tax leakage:
  - Ensure no withholding tax is imposed on payments on collateral obligations
    - Portfolio interest and other applicable exemptions
    - FATCA compliance, which requires access to information about investors
  - Avoid imposition of entity level tax on CLO Issuer
    - Avoid US trade or business by following detailed tax guidelines
    - Structure deal as partnership with no foreign partners
  - Ensure no withholding tax is imposed on payments on the Notes
    - Generally not an issue if CLO Issuer is FATCA compliant and not engaged in a US trade or business
    - CLO Issuers also require US withholding tax forms
- Investors in CLO securities are subject to complex US tax rules
  - Consequences turn on whether notes are debt or equity
  - Complex tax consequences and reporting obligations for equity holders under PFIC and potentially CFC rules
  - Added complexity for equity holders under NII Tax
  - TEOs investing in partnership CLOs or making a leveraged investment in CLOs need to be wary of UDFI