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International Tax Issues in the U.S. CLO Debt and Equity Tranches

Joung Keun Cho

Portfolio Analytics at Simone Investment Managers Internal Auditor to Trinity Asset Management U.S. Tax Advisor to Sellymon.com Assistant Professor of Finance, School of Business, Seokyeong University 1101 Yudam Hall, 124 Seokyeong-ro, Seoul 02713, Korea.
joungkec@alumni.cmu.edu

Abstract

CLOs are actively managed and their fee structure aligns the interests of the collateral manager with those of the investors by providing for payment of the significant management fees only after the CLO has paid off its debt and has achieved a specified hurdle rate of return on its equity tranche. The capitalized manager vehicle (CMV) structure facilitates this alignment of interests as well as the additional risk retention requirements. Tax leakage on the cash flowing from the underlying borrowers of the CLO's leveraged loans through the CLO issuer and into the hands of the noteholders can also occur at the level of payments by the CLO issuer, potentially decreasing their after-tax returns.

Keywords: *Collateralized Loan Obligations, Capitalized Manager Vehicle, Effectively Connected Income*

1. Introduction

A CLO is a financial tool used to re-package commercial loans into a product sold to investors in the secondary market - often organized as a foreign corporation - that holds a pool of collateralized debt. The U.S. tax consequences to a noteholder depend upon whether the notes it owns are debt or equity for U.S. 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 U.S. federal income tax purposes. While U.S. tax counsel in a CLO generally provides opinions that certain classes of rated notes "will be" or "should be" treated as debt for U.S. 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. Notes that receive only a "should" level opinion or no debt-for-tax opinion at all typically are ERISA restricted. [1]

U.S. CLO exposures offer both cross-border investments and flows of capital to Korean investors. How U.S. and Korean tax rules changes may impact Korean investors into U.S. CLO offerings and how it may affect their offshore CLO cash-on-cash recoveries are issues of critical importance. Since dividend payouts from CLO equities may constitute a substantial portion of return of capital realized on their investments, many exchange-listed U.S. business

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development corporations are utilizing their 30 percent non-conforming buckets to allocate to first-loss CLO equities. As a non-resident-alien investor with the only business in the U.S. are in positions such as stocks, mutual funds, hedge funds and etc., it is generally believed that the Korean investors may not subject to the U.S. capital gains tax and no money will be withheld by the U.S. withholding agents. Instead, the gains from the investment will be subject to capital gains and/or dividend income taxes, in case invested through an onshore-registered collective investment vehicle (CIV), in Korea.

The key related tax issues addressed herein are (1) U.S. reporting obligations; (2) Effectively Connected Income; and (3) Tax treaty benefits. Our study differs from to the existing literature in three ways. We first examine what taxation of Korean investors in offshore investment companies is. We subsequently make some comments about the latest U.S. Tax Cuts and Jobs Act ("Tax Act") of 2017 in terms of tax compliances. And, based on the newly evolved facts and circumstances in the U.S. regulatory environment, we elaborate seven different but highly relevant potential tax leakage risk points and the implications for Korean investors.

The remainder of this article is structured as follows: In section 2 we describe the U.S. and non-U.S. tax blocker subsidiaries and their current utility. In section 3 we describe the U.S. pass-through taxation on CMVs, in section 4 we document the Tax Act of 2017 in CLO investors in Korea and section 5 concludes.

2. The Tax Blocker Subsidiaries

The major source of cash of the CLO issuer is payments on its underlying loans and subsequent net trading gains. The CLO issuer needs those cash flows to make payments on its own securities. It is important to structure the system with the minimum possibility of suffering material tax leakage, which could arise either from the imposition of gross basis withholding tax on payments to the CLO issuer, as a result of the imposition of net income tax on the CLO issuer, or any issuer's gross-up payment obligations. Deals are coming with a tax redemption provision if the CLO issuer suffers tax leakage in excess of certain thresholds. A further level of tax leakage could arise as a result of withholding taxes on payments to the debt tranche holders. Debt holders typically are subject to net basis tax on the income they receive or accrue on their CLO securities. The way of debt holders to be taxed depends upon different factors such as: either U.S. persons or not; either tax-exempt entities or not; either holding debt or equity securities; whether debt classes were issued with original issue discount (OID) or not; whether the issuing entity may deem to be a passive foreign investment company (PFIC) or a controlled foreign corporations (CFC), and if the Issuer is a PFIC, whether an equity holder made a qualified electing fund (QEF) election or not.

However, a CLO issuer may receive equity securities in an operating partnership or other entity that would result in attribution of a U.S. trade or business to the CLO issuer in a workout of a collateral obligation. Activities in connection with the workout of a distressed collateral obligation could also cause the CLO issuer to become engaged in a U.S. trade or business. To mitigate the risk that such an asset or activity causes the CLO as a whole to be engaged in a U.S. trade or business, a CLO issuer is typically permitted to transfer the asset in question to a blocker subsidiary. A blocker subsidiary is the U.S. or a non-U.S. entity treated as a corporation for U.S. federal income tax purposes. It will be subject to U.S. net income tax and file U.S. tax returns. Blocker entity structures work because the IRS respects an entity that is deemed a corporation for U.S. tax purposes as an entity separate from the underlying shareholders and the blocker can transform income it receives into a different type of income for the shareholders' purposes. 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 a legal opinion that holding the asset directly will not cause the Issuer to be engaged in a U.S. trade or business is obtained.

If these CLOs are structured as entities that are transparent for U.S. federal income tax purposes, the CLO issuer should not be structured as a publicly traded partnership, which would be treated as a corporation for U.S. federal tax purposes. Since it is unclear whether the CLO issuer would have "qualifying income" under Code Sec. 7704, 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. Any note subject to such transfer restrictions is in a certificated form to allow for policing of the transfer restrictions.

If the CLO issuer is a partnership that is engaged in a U.S. trade or business, it would be required to withhold on income allocable to foreign partners under Code Sec. 1446 . Since the obligation to withhold and remit tax under Code Sec. 1446 would be imposed on the CLO issuer and would cut into the cashflow 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 U.S. persons. If there is only a single holder of the CLO's tax equity, the CLO issuer is classified as a disregarded entity and is not subject to withholding obligations under Code Sec. 1446.

U.S. withholding tax generally will apply to equity securities of U.S. issuers the CLO issuer receives as a result of commercial loan workouts. The issuer in a U.S. CLO transaction is typically established outside of the U.S., principally to avoid being liable to pay U.S. federal income tax on its global income. When a portfolio asset is exchanged for equity or other assets in connection with bankruptcy or workout proceedings, this may nonetheless cause the CLO issuer to be deemed to be engaged in a trade or business in the U.S. which would subject the entire CLO portfolio to U.S. federal tax. If CLO indentures provide for the formation of tax subsidiaries to hold such equity, it helps to avoid the forced disposal of distressed assets at the worst timing and gives the CLO the benefit of any workout upside. In the U.S., there has been a growing acceptance in the formation of tax blocker subsidiaries for existing U.S. CLO issuers with the experience of recently failed oil and gas companies. These blocker entities can hold equity or other workout assets issued in connection with the restructuring of problem loans. This mitigates any tax risk that the associated CLO will be engaged in a U.S. trade or business.

The formation of Delaware limited liability companies and Delaware corporations as subsidiary tax blocker vehicles of CLO issuers are more commonly adopted. Upon formation, the relevant defaulted assets can be transferred by or on behalf of the CLO issuer to the subsidiary LLC or corporation. However, U.S. tax structuring requirements, including the jurisdiction of choice for the tax subsidiary, will be dictated by matters such as the nature of the defaulted asset or activity in question. In addition, provisions in the CLO indenture typically restrict the formation of subsidiaries unless specified conditions precedent are triggered and prescribed remedies are followed.

Equity investors in CLOs organized as foreign corporations must consider rules related to CFCs. A foreign corporation is a CFC if more than 50 percent of its value or voting power is owned by U.S. investors who own at least 10 percent of the corporation ("U.S. shareholders"). U.S shareholders must include their pro-rata share of a CFC's Subpart F income in their current taxable income, whether distributed or not. Furthermore, a foreign corporation is a PFIC if 75 percent or more of its gross income is passive (e.g., interest and dividends) or at least 50 percent of its assets are held for the production of passive income. Most foreign CLOs are PFICs, and all equity investors in PFICs, including less-than-10 percent shareholders in CFCs, are subject to an anti-deferral regime, which implies complex and costly reporting requirements. In addition, capital gain and certain deferred interest income are taxed as ordinary income at the highest federal rate of 37 percent regardless of the individual investor's actual marginal rate. Plus, they're subject to an interest charge on the tax related to the PFIC income as if the income were received ratably over the holding period.

3. U.S. Pass-Through Taxation

The majority of U.S. hedge funds and the CMV of CLOs were established as limited partnerships governed by a limited partnership agreement. The CMV agreement includes the original agreement and any modifications. Partners can modify the CMV agreement for a particular tax year after the close of the year but not later than the date for filing the CMV return for that year without an extension of time. Limited partners are the passive participants, therefore are not involved in the CMV's investment decisions or other daily activities. They just contribute their capital to the CMV and receive in return partnership interests and a capital account. Limited partners are typically shielded from personal liability for the CMV's debts and actions, except to the extent of their capital contribution, plus any distributions made by the partnership to the limited partners. On the other hand, the legacy collateral manager is responsible for the hands-on operation of the CMV and has the power to bind the CMV and the other partners in contracts. The legacy collateral manager assumes personal liability for all of the debts and other obligations of the CMV.

To mitigate such risk down to negligible economic liability, many legacy collateral managers are formed as a limited liability company (LLC) and the legacy collateral managers also contribute a minimum amount of capital to the CMV by aligning interests with other passive limited partners. While it offers the protection of limited liability under the securities laws, the ultimate personal liability will be borne by the legacy collateral manager anyway irrespective of the legal form of the entity that serves as the general partner.

LLC is an entity formed under state law by filing articles of organization as an LLC. Unlike a CMV partnership, none of the members of an LLC are personally liable for its debts. An LLC may be classified for the U.S. federal income tax purposes as either a partnership, a corporation, or disregarded as an entity separate from its owner. A domestic LLC with at least two members that does not file Form 8832 (Entity Classification Election) is classified as a partnership for the U.S. federal income tax purposes. An eligible entity is classified for federal tax purposes under the default rules unless it files Form 8832 or Form 2553 (Election by a Small Business Corporation, S corporation) to elect a classification or change its current classification. If no election is made, default rules apply such that a domestic eligible entity is a partnership if it has two or more members and disregarded as an entity separate from its owner if it has a single owner.

Many legacy collateral and hedge fund managers set up the investment manager as another partnership, with some of the investment professionals as limited partners and another LLC as the general partner, therefore, limiting any potential liabilities by one more layer. Delaware doesn't require the fund to maintain a presence or office or personnel in the state and doesn't require filing a private limited partnership agreement and become one of the most popular U.S. states for the incorporation of limited partnerships and its associated general partner LLC. The limited partnerships and its associated general partner LLC will have a resident agent and a physical address in the state, but none of their business physically takes place in there. Then the legacy collateral and hedge fund managers establish a principal place of business in other states which have competitive advantages in state and local tax rates on the pass-through general partner LLC.

4. Latest Development in CLO Regulation

In 2014, the Loan Syndications and Trading Association filed a lawsuit against the Federal Reserve and the Securities and Exchange Commission (SEC), arguing that the credit risk retention rule was arbitrary, capricious, and an abuse of discretion. In December 2016, a D.C. District Court held that collateral managers of both open-market and middle-market CLOs were considered securitizers for purposes of the credit risk retention rule.

However, according to a recent ruling by the DC Circuit Court issued on February 9, 2018, the credit risk-retention rules may no longer apply to the open-market CLOs, which do not fall under the definition of securitizers and need not comply with risk retention. Clearing the regulatory hurdle is positive for CLO managers and could support more primary market activity and also likely create some spread widening pressure on CLO debt tranches. In the meantime, the majority of middle-market CLO managers still under the definition of securitizers and will continue to comply with risk retention. The Federal Reserve and SEC have 45 days to seek en banc review of the decision before the D.C. Circuit Court and 90 days to seek certiorari from the U.S. Supreme Court. If regulators do not appeal the decision, open-market CLO managers can then begin structuring new deals without obligation of the “skin on the game.”

The Circuit Court focused on Dodd-Frank’s definition of a securitizer as being an entity that transfers assets to an issuer of securities, and it noted that open-market CLO managers typically do not own the assets underlying the CLO and therefore do not transfer them to the issuer. Rather, these managers select assets to be purchased by the issuer from third parties on the open market. Because open-market CLO managers are not securitizers, they are not obligated to retain any credit risk in the CLOs they manage. The D.C. Circuit Court’s decision effectively groups open-market CLO managers with other asset managers rather than with securitizers of asset-backed securities.

Middle-market CLOs are a subset of CLO issuers. Most CLOs acquire broadly syndicated loans on the secondary market. These broadly syndicated CLOs usually are treated as foreign corporations for U.S. tax purposes and typically are organized in the Cayman Islands, which does not impose an income tax, or in Ireland, the Netherlands or Luxembourg, which permit interest deductions on the CLO notes to effectively eliminate any home jurisdiction income tax. U.S. collateral managers of broadly syndicated CLOs comply with “U.S. tax guidelines” that allow the CLO to satisfy a safe harbor that ensures that the CLO is not engaged in a U.S. trade or business, thus is not subject to U.S. net income tax.

By contrast, middle-market CLOs invest primarily in middle-market loans. Because the secondary market for middle-market loans is less developed than that for broadly syndicated loans, middle-market CLOs often act as original lenders on the loans instead of buying loans on the secondary market. Since any activities of regularly lending money through a U.S. collateral manager as an agent constitutes a U.S. trade or business for U.S. tax purposes, a foreign corporate CLO that is engaged in a U.S. trade or business potentially is subject to U.S. corporate-level tax.

By contrast, entities that are treated as partnerships for U.S. tax purposes and are engaged in a U.S. trade or business generally are not subject to entity-level tax so long as their equity is held exclusively by U.S. persons. Accordingly, to avoid U.S. entity-level tax, most middle-market CLOs are structured as partnerships for U.S. tax purposes and require any notes they issue to be held by U.S. persons unless the notes receive a legal opinion that they will be treated as debt for U.S. tax purposes. Tax counsel is known to give such a "will be debt" opinion only with respect to a middle-market CLO's investment-grade notes.

5. Conclusion

Cash moves through the structure with minimal tax leakage to ensure no withholding tax is imposed on payments on collateral obligations is one of the key issues in a CLO design. We make detailed comments about the latest U.S. Tax Cuts and Jobs Act ("Tax Act") of 2017 in terms of tax compliances. From the newly evolved facts and circumstances in the U.S. regulatory environment, our seven potential tax leakage risk points for Korean investors are believed to be relevant from the initial investment structuring to the on-going tax compliances.

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Author

Dr. Cho Joung Keun
Senior Portfolio Analytics to Simone Investment Managers, Internal Auditor to Trinity Asset Management, U.S. Tax dvisor to Sellymon.com, and Assistant Professor, School of Business Administration, Seokyeong University, 1101-1 Yudam Hall, 124 Seokyeong-ro, Seoul 02713, Korea.
E-mail: joungkec@alumni.cmu.edu

Professor Cho received a D.B.A. in Finance (*Dean's Honor Roll*) from PSB Paris School of Business at *l'École Supérieure de Gestion*, an M.B.A. in finance from the Executive Program at the Tepper School of Business of Carnegie Mellon University, an M.B.A. in int'l wealth management from *l'Université de Genève/HEC*, an M.A. in economics from the University of Oklahoma, and a B.A. in economics from Yonsei University, Seoul. He has published a several research articles on the topics of dynamic asset allocation, implied volatilities, volatility entropy indicators within the framework of portfolio management, various topics of hedge funds, the securitized commercial mortgage loan products and the embedded implications to the cross-border tax planning issues.

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