Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Tax Reform Complicates Middle-Market CLOs

By **Jason Schwartz, Nathan Spanheimer and Cassidy Nolan**
(March 9, 2018, 12:57 PM EST)

Jason Schwartz

Nathan Spanheimer

Cassidy Nolan

The recently enacted Tax Cuts and Jobs Act is causing concerns for advisers of middle-market collateralized loan obligation issuers, or MM CLOs, that are engaged in a U.S. trade or business for U.S. tax purposes.[1] The TCJA includes Section 1446(f) of the Internal Revenue Code,[2] which potentially imposes a withholding requirement on any purchaser of noninvestment-grade notes issued by an MM CLO, or an entity-level tax on the MM CLO itself, unless the seller of the notes furnishes the purchaser with a "nonforeign affidavit" containing the seller's U.S. taxpayer identification number and stating, under penalties of perjury, that the seller is not a foreign person.[3]

Although investors in noninvestment grade notes issued by MM CLOs typically are restricted to U.S. persons, the deal documents for MM CLOs historically have not included a mechanism requiring a seller to provide a nonforeign affidavit to the purchaser, and purchasers might not be aware of the requirement to obtain a nonforeign affidavit or to withhold on sellers that fail to provide the affidavit. Moreover, because many MM CLO notes are traded through a depository institution, such as the Depository Trust Company, (1) a purchaser might not easily be able to withhold on the seller, and (2) an MM CLO might have difficulty determining whether withholding was properly effected.

In 2017, MM CLO issuances in the United States reached a pre-crisis high of $14.7 billion.[4] Investors in MM CLOs do not expect an incremental tax drag on their investment returns, and MM CLOs generally must eliminate entity-level tax in order to receive a credit rating with respect to the senior and mezzanine notes that they issue. A failure by MM CLOs to require sellers of noninvestment-grade notes to deliver a nonforeign affidavit to both the purchaser and the MM CLO could adversely affect investors in both existing and future MM CLOs.

Overview of MM CLOs

MM CLOs are a subset of collateralized loan obligation issuers. CLOs are actively managed special-purpose vehicles that typically issue notes to institutional investors and use the proceeds primarily to acquire commercial loans.[5] Interest and, after a specified

reinvestment period of four to five years, principal received by CLOs on their assets are used to pay interest and principal on the notes. CLOs hire collateral managers to manage their assets in exchange for management fees.

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 and is not subject to U.S. net income tax.

By contrast, MM CLOs invest primarily in middle-market loans. Because the secondary market for middle-market loans is less developed than that for broadly syndicated loans, MM CLOs often act as original lenders on middle-market loans instead of buying loans on the secondary market.

The IRS asserts that regularly lending money through a U.S. agent (such as a U.S. collateral manager) constitutes a U.S. trade or business for U.S. tax purposes.[6] 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 MM 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 an opinion of tax counsel that they will be treated as debt for U.S. tax purposes. Tax counsel typically gives such a "will be debt" opinion only with respect to an MM CLO's investment-grade notes.

Section 1446(f) Generally

Section 1446(f) requires a purchaser of an equity interest in a partnership that is engaged in a U.S. trade or business for U.S. tax purposes (such as an MM CLO) to withhold 10 percent of a foreign seller's amount realized. If the purchaser fails to withhold, then the partnership is required to withhold on future distributions to the purchaser, and could be subject to an entity-level tax liability if it fails to do so.

Section 1446(f) generally is intended to enforce Section 864(c)(8), which also was included in the TCJA. Under Section 864(c)(8), a foreign partner is subject to U.S. income tax on any gain that it recognizes on a sale or redemption of an equity interest in a partnership that is engaged in a U.S. trade or business to the extent that the foreign partner would have been subject to U.S. income tax if, on the date of the sale or redemption, the partnership had sold all of its assets at fair market value.[7] Any withholding under Section 1446(f) generally may be credited against the foreign partner's ultimate U.S. tax liability.

Application of Section 1446(f) to MM CLOs

The primary withholding requirement under Section 1446(f) is intended to apply only to a purchaser of partnership equity from a foreign partner. As mentioned above, MM CLOs restrict the ownership of their notes to U.S. persons unless the notes receive an opinion of tax counsel that they will be debt for U.S. tax purposes. Accordingly, as a policy matter, Section 1446(f) should not impose a withholding requirement on purchasers of MM CLO notes, because the transfer restrictions contained in an MM CLO's deal documents require each seller to be either (1) a U.S. person or (2) a debt holder.

Unfortunately, however, the only bright-line exception from withholding liability under the statutory language of Section 1446(f) is if the seller furnishes the purchaser with a nonforeign affidavit containing the seller's U.S. taxpayer identification number and stating, under penalties of perjury, that the seller is a U.S. person. As a result, a purchaser of noninvestment-grade notes (which, as noted above, do not receive an opinion that they are debt for U.S. tax purposes) risks incurring liability for failing to withhold on a seller if (1) the notes are treated as equity, (2) the purchaser relies solely on the MM CLO's transfer restrictions to assume that the seller is a U.S. person, and (3) the seller is, in fact, a non-U.S. person (in contravention of the MM CLO's transfer restrictions). Moreover, in this event, the MM CLO is required to withhold on future distributions to the purchaser to the extent that the purchaser failed to withhold on the seller and, if the MM CLO does not withhold, then it may be subject to entity-level tax liability for failure to do so (which would reduce amounts available for distribution to investors).[8]

When a seller directly sells a physical MM CLO note to a purchaser, the MM CLO can require the purchaser to ask the seller for a nonforeign affidavit to comply with Section 1446(f), and to withhold on any seller that fails to provide the affidavit. However, as mentioned above, many MM CLO notes are traded through a depository institution, such as the Depository Trust Company. What this means is that the depository institution is the registered holder of a "global" certificate that entitles it to payments on the MM CLO's notes, and brokers that have a relationship with the depository institution purchase interests in the global certificate on behalf of their clients.

It is unclear how withholding would be effected through a depository institution, which is unlikely to register a transfer of beneficial ownership of an MM CLO note unless it receives the note's full purchase price (without withholding). In addition, interposing a depository institution (as well as relationship brokers) between a purchaser and a seller potentially creates communication issues between the MM CLO, the purchaser and the seller, which could make it difficult for the MM CLO to determine whether a purchaser received a nonforeign affidavit or whether withholding was properly effected.

Documentary Solutions

One possible way for MM CLOs to address Section 1446(f) going forward would be to require each seller of a noninvestment-grade note to furnish the purchaser and the indenture trustee with a nonforeign affidavit as a condition to registering the sale. This would likely satisfy the bright-line withholding exemption in Section 1446(f), and therefore should absolve both the purchaser and the MM CLO from liability if the notes are treated as equity and the seller is not, in fact, a U.S. person. However, it remains to be seen whether any communication issues between sellers and purchasers will arise (in particular with respect to notes held in global form) in connection with this requirement.

It is unclear how Section 1446(f) will affect MM CLOs that closed before its enactment in the absence of an amendment to their deal documents to adopt the approach mentioned above, but there is a risk that the provision will adversely affect the liquidity of their global noninvestment-grade notes. Moreover, in the event that (1) an MM CLO's notes are treated as equity, (2) a purchaser does not withhold on a seller, and (3) the seller turns out to be a non-U.S. person, the IRS might assess a liability on the MM CLO for failing to withhold on the purchaser. This liability would be payable as an administrative expense and likely would be borne economically by the holders of the MM CLO's equity.

Closing Observations

The IRS has broad authority to issue regulations and other official guidance under Section 1446(f),[9]

and has already exercised this authority to temporarily suspend the application of Section 1446(f) to purchasers of publicly traded partnership interests pending the issuance of regulations.[10]

From a U.S. tax perspective, a depository institution's role in effecting transfers of global notes is similar to a clearing institution's role in effecting transfers of publicly traded partnership interests. In both cases, the institution's involvement could create communication issues between a seller, purchaser and issuer, could prevent a purchaser from being able to withhold on the seller, and could prevent the issuer from knowing whether withholding was effected. Accordingly, advisers of MM CLOs might reasonably hope for a similar suspension.[11] In the meantime, however, they must be creative and thoughtful in mitigating the potential adverse effects of Section 1446(f) on the MM CLO market.

Jason Schwartz is a partner in the tax group at Cadwalader Wickersham & Taft LLP. Nathan Spanheimer is a partner and Cassidy Nolan is an associate in Cadwalader's capital markets group. *The authors would like to thank Cadwalader capital markets partner Gregg Jubin for his contributions to this article.*

[1] The concern discussed in this article applies only to MM CLOs (and any other CLOs) that are engaged in a U.S. trade or business for U.S. tax purposes.

[2] All references to section numbers herein are to the U.S. Internal Revenue Code of 1986, as amended.

[3] MM CLOs might issue interests in the form of notes, limited partnership interests or limited liability company interests. For convenience, this article refers to MM CLO interests as "notes."

[4] Fitch Ratings, Fitch: Strong CLO Appetite Keeps Issuance at Highs (Jan 25, 2018), available at https://www.fitchratings.com/site/pr/1035574.

[5] For a detailed discussion of the structure and taxation of CLOs, see Jason Schwartz and David S. Miller, Collateralized Loan Obligations, 6585 Tax Mgmt. Port. (BNA) (2018).

[6] See AM 2009-010.

[7] Section 864(c)(8) is intended to codify the IRS' conclusion in Revenue Ruling 91-32. In 2017, the Tax Court rejected this conclusion and held that a foreign partner was not subject to U.S. income tax on a redemption of an equity interest in a partnership that was engaged in a U.S. trade or business except to the extent that the gain was attributable to U.S. real property interests. See Grecian Magnesite Mining v. Commissioner, 149 T.C. No. 3(July 13, 2017). Section 864(c)(8) effectively overrides Grecian Magnesite Mining.

[8] Before tax reform, Section 1446(a) required MM CLOs to withhold on income and gain allocated to foreign partners. To eliminate this withholding requirement, the deal documents for most MM CLOs require purchasers of noninvestment-grade notes to provide the indenture trustee with an IRS Form W-9 certifying that the purchasers are U.S. persons. An MM CLO generally may rely on an IRS Form W-9 to eliminate Section 1446(a) withholding liability in the absence of actual knowledge or reason to know

that the form is inaccurate. See Treas. Reg. Section 1.1446-1(c)(2)(iii).

However, it is unclear whether Section 1446(f) allows an MM CLO to rely on an IRS Form W-9, even though there is no obvious policy reason to prohibit such reliance. See New York State Bar Association, Request for Immediate Guidance under Sections 864(c)(8) and 1446(f), Report No. 1387, at 8 (Feb. 2, 2018) (requesting guidance confirming that an IRS Form W-9 qualifies as a nonforeign affidavit). Thus, even if an MM CLO has an IRS Form W-9 on file with respect to a seller of noninvestment-grade notes, it is possible that the MM CLO will have withholding liability under Section 1446(f) if the purchaser does not receive a nonforeign-affidavit from the seller and does not withhold.

[9] See section 1446(f)(6) ("The Secretary shall prescribe such regulations or other guidance as may be necessary to carry out the purposes of this subsection, including regulations providing for exceptions from the provisions of this subsection."); Section 1446(g) ("The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section.").

[10] See Notice 2018-08 (acknowledging concerns that, "in the case of a disposition of a publicly traded partnership interest, applying new section 1446(f) without guidance presents significant practical problems").

[11] Although the suspension applies only to publicly traded partnership interests, the notice also requests comments on "whether a temporary suspension of new section 1446(f) for partnership interests that are not publicly traded partnership interests is needed." See also New York State Bar Association, Request for Immediate Guidance under Sections 864(c)(8) and 1446(f), Report No. 1387, at 4 (Feb. 2, 2018) ("[W]e recommend that either (i) Treasury and the Service issue immediate guidance that addresses the most pressing issues regarding the manner in which withholding under Section 1446(f) is to be conducted or (ii) if workable guidance cannot be issued in a very short period of time, the application of withholding for all partnership interests be delayed until regulations or other guidance is issued.").