The Taxation of CLO Risk Retention Structures

By Jason Schwartz, Jean Bertrand, and Sejin Park*

Jason Schwartz, Jean Bertrand, and Sejin Park examine a tax structure that U.S. collateral managers of collateralized loan obligation issuers commonly use to comply with the U.S. and European "risk retention" rules enacted following the 2007–2008 global financial crisis that require sponsors of securitization vehicles to maintain a financial interest in those vehicles.

I. Introduction

In the wake of the 2007–2008 global financial crisis, the United States and Europe enacted "risk retention" rules that require sponsors of securitization vehicles to maintain a financial interest in those vehicles (*i.e.*, "skin in the game"). This article examines one tax structure that U.S. collateral managers of collateralized loan obligation issuers ("CLOs") commonly use to comply with these rules. At the heart of this structure is an entity called a capitalized management vehicle, or "CMV."

On February 9, 2018, the U.S. Court of Appeals for the D.C. Circuit held that U.S. collateral managers of CLOs are not "securitizers" and therefore are not required to retain a financial interest in the CLOs under the U.S. risk retention rules.[1] However, whether or not the government appeals this decision, U.S. collateral managers of CLOs must continue to comply with the European risk retention rules (which, as discussed below, are similar to the U.S. rules) if they want the CLOs to be able to issue notes to certain European investors. Moreover, U.S. collateral

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managers that have already set up CMVs to comply with the U.S. rules might, as a practical matter, be locked into their structures for a considerable period of time to come.

As described in greater detail below, to comply with the risk retention rules, many U.S. collateral managers organize a CMV, which is treated for U.S. tax purposes as a partnership between themselves and third-party investors. The CMV manages CLOs and uses money contributed primarily by the third-party investors to acquire interests in the CLOs. In exchange for their cash contribution to the CMV, the third-party investors are entitled to receive (1) the regular investment return on the CLO interests that the CMV acquires, which consists of payments made in respect of those interests pursuant to the priority of payments contained in the CLO's indenture, plus (2) an "increased return" on the most subordinated class of interests (which are commonly referred to as the "subordinated notes") that the CMV acquires. The increased return effectively compensates investors in the CMV for serving as indirect "anchor investors" in the CLOs[2] and is payable as a result of a corresponding reduction in the management fees that the CMV charges the CLOs.

Third-party investors who are foreign persons for U.S. tax purposes would be subject to U.S. income tax if any part of their allocable share of income from the CMV were characterized as fee income from services performed within the United States (*i.e.*, U.S.-source management fees). Accordingly, U.S. tax advisors reviewing proposed risk retention structures must ensure that third-party foreign investors in the CMV are allocated solely investment returns, and not fee income.

The stakes are high: CLOs are consistently the largest non-bank investors in commercial loans. A general inability of U.S. collateral managers to comply with the risk retention rules could dramatically reduce credit availability for U.S. and European companies and increase their financing costs. Moreover, CLOs are an important source of fee income for many U.S. collateral managers.

Part II of this article briefly explains what a CLO is.[3] Part III summarizes the application of the risk retention rules to CLOs and provides an overview of a typical CMV structure. Part IV explains why the foreign entity through which foreigners invest should not be subject to U.S. income tax. Part V discusses the use of a Delaware corporation to "block" certain income.

II. What Is a CLO?

CLOs are actively managed special purpose vehicles that issue notes primarily to institutional investors and use the proceeds primarily to acquire broadly syndicated commercial loans. 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 that the CLOs issue. CLOs hire collateral managers to manage their assets in exchange for management fees.[4]

CLOs usually are treated as foreign corporations for U.S. tax purposes and usually 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.[5] U.S. collateral managers 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.

III. Application of the Risk Retention Rules to U.S. Collateral Managers of CLOs

A. In General

The U.S. risk retention rules are contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and guidance issued thereunder.[6] One of the legislation's stated purposes is "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system."[7] To this end, the U.S. risk retention rules are intended to align the interests of securitization "sponsors" and securitization investors by requiring the sponsors to retain at least 5% of the credit risk underlying the securitized assets.

As applied to CLOs, the U.S. rules—before the U.S. Court of Appeals decision—generally required the collateral manager or a majority-owned affiliate (an "MOA") of the collateral manager of any CLO that issued notes on or after December 24, 2016, to U.S. investors to acquire and retain either (x) 5% of the face amount of each class of notes issued by the CLO (an "eligible vertical slice"), (y) notes of the most subordinated class issued by the CLO representing, in the aggregate, 5% of the fair value of all notes issued by the CLO (an "eligible horizontal slice"), or (z) a combination of an eligible vertical slice and an eligible horizontal slice representing, in the aggregate, 5% of the fair value of all notes issued by the CLO (an "L-shaped slice"). As a practical matter, most CLO risk retention structures to date have opted to retain an eligible horizontal slice. For convenience, we refer to an eligible vertical slice, an eligible horizontal slice, or an L-shaped slice as the "risk retention notes."

The European risk retention rules are contained in the Capital Requirements Regulation (EU) No. 575/2013 of the European Parliament and of the Council of June 26, 2013. The stated purpose and application of these rules to CLOs are very similar to the stated purpose and application of the U.S. risk retention rules,[8] with two significant exceptions. First, under the European rules, the retaining entity generally must be the named collateral manager.[9] Second, to be eligible to hold the risk retention notes under the European rules, most U.S. collateral managers have to qualify as "originators" by acquiring 5–10% of each CLO's target fully-ramped portfolio (by face amount) on the secondary market at least 15 business days before the CLO's closing date and selling the loans to the CLO on the closing date.[10] Although these sales may be effected pursuant to a forward sale agreement, the CLO is not required to purchase any loans that default within the 15-day seasoning period; thus, during the seasoning period, a U.S. collateral manager complying with the European risk retention rules bears credit risk with respect to the loans that it acquires.

B. The CMV Structure

Historically, collateral managers have not had sufficient capital on hand to acquire significant interests in the CLOs that they have managed. Accordingly, to comply with the risk retention rules, U.S. collateral managers often rely on funding from third-party investors by organizing a CMV that is substantially capitalized with third-party money. The CMV, in turn, acquires the risk retention notes and acts as the collateral manager of the applicable CLOs.

A CMV is a *new* collateral manager with business operations that are distinct from the legacy collateral manager. The legacy collateral manager is not required to contribute any money to the CMV (although, for commercial reasons, third-party investors may require the legacy collateral manager to provide 5–15% of the CMV's capital). The CMV develops a dedicated business platform for managing CLOs, including (if necessary) by hiring collateral management personnel from the legacy collateral manager. The legacy collateral manager might contribute intellectual property (*e.g.*, trademarks) to the CMV, and the CMV typically hires the legacy collateral manager to provide operational, credit research, and back-office support, and access to its systems and facilities. However, the CMV (and not the legacy collateral manager) must enter into the management agreements with the CLOs and must establish that it operates independently from the legacy collateral manager.[11]

A CMV typically is structured as a newly formed Delaware series limited liability company (an "LLC") or series limited partnership (an "LP") that, in either case, is treated as a partnership for U.S. tax purposes. The CMV typically designates one series ("Series A") to receive all collateral management fees, another series ("Series B") to receive all proceeds on the risk retention notes, and a third series ("Series C") to receive all income and gain with respect to any loans that the CMV acquires and sells to qualify as an originator under the European risk retention rules, in each case net of any related expenses. The legacy collateral manager (often through a wholly owned affiliate) holds all of the Series A interests, and thus is allocated all of the collateral management fees that the CMV receives, net of any expenses related to the CMV's management activities. If the legacy collateral manager (or its affiliate) contributes cash to the CMV, then it also holds a *pro rata* share of the Series B interests and Series C interests, and thus is allocated a *pro rata* share of any payments that the CMV receives on the risk retention notes and a *pro rata* share of any income and gain on loans that the CMV acquires and sells, net of any related expenses.

In the wake of the 2007–2008 global financial crisis, the United States and Europe enacted "risk retention" rules that require sponsors of securitization vehicles to maintain a financial interest in those vehicles (i.e., "skin in the game").

The composition of the rest of the risk retention structure will depend on the organizational structure of the legacy collateral manager, the types of investors, and other factors.[12] However, this article contemplates the "paradigm structure" illustrated in Annex 1 for the sake of discussing the most important tax considerations applicable to a CMV structure. The paradigm structure has the following key players in addition to the CMV and the legacy collateral manager:

- *The Foreign Blocker*. Foreign investors and U.S. tax-exempt investors invest in the CMV through a foreign (typically Cayman Islands or Jersey) "blocker" entity that is treated as a corporation for U.S. tax purposes.[13] The foreign blocker invests substantially all of its cash directly into the CMV in exchange for Series B interests and is allocated a *pro rata* portion of any payments that the CMV receives on the risk retention notes.

- *The Delaware Blocker*. As discussed in greater detail in Part V, some tax advisors are concerned that qualifying as an originator under the European risk retention rules could cause the CMV to recognize income that is effectively connected with a U.S. trade or business for U.S. tax purposes. Accordingly, any interest income that the CMV recognizes on the loans before selling the loans to CLOs and any gain that the CMV recognizes on the sales are allocated to the Series C interest holders, which comprise (1) U.S. investors and (2) a newly formed Delaware "blocker" entity that is treated as a corporation for U.S. tax purposes. The Delaware blocker files U.S. federal income tax returns and pays U.S. federal income taxes on the income and gain allocated to it.[14]
- *Foreign Investors and U.S. Tax-Exempt Investors*. Foreign investors and U.S. tax-exempt investors invest into the foreign blocker and the Delaware blocker and receive distributions from each of these entities.[15] Dividends that the Delaware blocker pays to foreign investors are subject to 30% U.S. withholding tax (which may be reduced by an applicable income tax treaty). Distributions by the foreign blocker are not subject to U.S. withholding tax.
- *U.S. Taxable Investors*. U.S. taxable investors invest directly in the Series B and Series C interests and are allocated a *pro rata* portion of any payments that the CMV receives on the risk retention notes, as well as a *pro rata* portion of any income and gain recognized by the CMV with respect to any loans that it acquires and sells to the CLOs whose risk retention notes it holds.

As noted above, third-party investors in a CMV are entitled to the investment return on the risk retention notes. This return exceeds the regular return payable on the risk retention notes pursuant to the notes' payment waterfall by an amount commonly referred to as the "increased return."

The CLO typically pays the increased return to the CMV under a side letter pursuant to which (1) the CLO contractually agrees to distribute on the subordinated notes that are risk retention notes (in addition to the amounts to which the notes are otherwise entitled under the indenture) an additional amount, based on a specified formula; (2) the collateral management fees are contractually reduced by the same amount[16]; and (3) the parties agree to treat the additional amount as part of the investment return on the risk retention notes (and not as a share of the management fees).[17] The additional amount is payable on the risk retention notes regardless of whether the management agreement is terminated, and regardless of whether the risk retention notes are held by the CMV or transferred to another person.[18]

IV. Avoiding ECI for the Foreign Blocker

A. In General

Because the CMV's personnel provide collateral management services from within the United States, the CMV is treated as engaged in a trade or business in the United States.[19] As a result, because the foreign blocker is a partner in a partnership that is engaged in a U.S. trade or business, it is also considered to be engaged in a U.S. trade or business by reason of its investment in the CMV, is required to file U.S. tax returns,[20] and is subject to U.S. federal income tax on its allocable share (if any) of the CMV's effectively connected income ("ECI").[21]

ECI of a foreign corporation (such as the foreign blocker) generally is taxed in the same manner as the income of a U.S. corporation.[22] A foreign corporation that is engaged in a U.S. trade or business is also subject to a 30% "branch profits tax" on its "dividend equivalent amounts" (which generally is a measure of the foreign corporation's effectively connected earnings and profits that are not reinvested in the U.S. business and are deemed repatriated offshore in any year).[23] Finally, entities that are treated as partnerships for U.S. tax purposes and are engaged in a U.S. trade or business (such as the CMV) are required to withhold tax at the highest applicable rate (which currently is 21% for corporations) on their foreign partners' distributive share of any income that is effectively connected with that trade or business.[24] Accordingly, it is crucial that any profits that the CMV allocates to the foreign blocker not be ECI.

The CMV allocates two types of profits to the foreign blocker: (1) the "regular" return on the risk retention notes and (2) the "increased return" on the risk retention notes.[25] We discuss each of these profit types in turn.

B. Regular Return on Risk Retention Notes

1. Overview

The rules for determining whether the CMV's income from the risk retention notes is ECI are different depending on whether the income is U.S.-source or foreign source. As discussed below, there is a greater risk that the income will be ECI if it is U.S.-source. A substantial portion of income on the risk retention notes would be U.S.-source if the CLOs are treated as partnerships for U.S. tax purposes. By contrast, none of the income on the risk retention notes is U.S.-source if the CLOs are treated as foreign corporations for U.S. tax purposes. Accordingly, CMVs typically ensure that the CLOs that they manage are all treated as foreign corporations for U.S. tax purposes.[26]

2. CLOs Treated as Foreign Corporations

a. In General. For U.S. tax purposes, a foreign corporate CLO is treated as either a passive foreign investment company (a "PFIC") or a controlled foreign corporation (a "CFC").[27] In either case, the CMV generally will be required to include a *pro rata* share of the CLO's net income and gain in income each year in respect of the subordinated notes.[28] Subsequent distributions from the CLO on the subordinated notes generally will consist of "previously taxed income" and thus will not be subject to tax again.[29] There are no rules for determining whether income inclusions under the PFIC or CFC rules are treated as ECI. However, foreign-source dividends provide the best analogy for these inclusions, since the inclusions are income in respect of equity.[30]

The CMV might also realize foreign-source interest from CLOs on any risk retention notes that are not subordinated notes.[31]

There is no guidance for determining whether foreign-source dividends or interest received by a domestic partnership (such as the CMV) are ECI. However, Code Sec. 864(c)(4) generally provides that foreign-source dividends or interest received by a foreign corporation are *not* ECI unless (i) either (A) the dividends or interest are derived in the active conduct of a banking, financing, or similar business within the United States or (B) the principal business of the foreign corporation is trading in stocks or securities for its own account (the "activities test"), and (ii) the foreign corporation has an office or other fixed place of business within the United States to which the dividends or interest are attributable (the "nexus test"). Code Sec. 864(c)(4) should apply equally to foreign-source dividends or interest received by a partnership that has one or more foreign corporate partners; otherwise, foreign corporations would be able to use partnerships to "block" ECI with respect to businesses that satisfy the activities test or nexus test.

Moreover, the IRS has informally advised that, even if income derived by a partnership is not effectively connected with that partnership's U.S. trade or business, the income may still be treated as effectively connected with a partner's U.S. trade or business.[32] Accordingly, to conclude that a CMV's income is not ECI to the foreign blocker, the test in Code Sec. 864(c)(4) should be applied separately to each of the CMV and the foreign blocker. As discussed below, neither the CMV nor the foreign blocker should satisfy the activities test described above—that is, neither should be treated as (A) being in the active conduct of a banking, financing, or similar business within the United States or (B) trading in stocks and securities for its own account as its principal business.[33]

b. Banking, Financing, or Similar Business. In general, a foreign corporation will be treated as engaged in the active conduct of a banking, financing, or similar business in the United States only if (i) at some point during the taxable year, the foreign corporation is engaged in business in the United States, and (ii) the activities of that business consist of making personal, mortgage, industrial, or other loans to the public, issuing letters of credit to the public and negotiating drafts drawn under those letters of credit, or other specified activities.[34] The CMV provides collateral management services to CLOs, purchases and holds notes issued by the CLOs, and, when qualifying as an originator under the European risk retention rules, purchases loans on the secondary market and sells the loans to the CLOs. The foreign blocker purchases and holds interests in the CMV and is allocated dividends and interest from the risk retention notes. Neither the CMV nor the foreign blocker makes loans to the public, issues letters of credit to the public, negotiates drafts or engages in any of the other activities constituting a banking, financing or similar business. Accordingly, the dividends and interest that the CMV receives and allocates to the foreign blocker should not be treated as derived from a banking, financing or similar business in the United States.

c. Principal Business of Trading. Code Sec. 864 and the regulations thereunder do not define what it means for the principal business of a foreign corporation to be "trading" in stocks and securities for its own account. However, the regulations do differentiate between trading and investing and provide that dividends derived from incidental investment activities are not ECI.[35] Generally, the distinction between a person that conducts mere investment activities (*i.e.*, an "investor") and a person who is engaged in the business of trading (*i.e.*, a "trader") is that the trader's activities are "frequent, continuous, and regular," whereas the investor's activities are "more isolated and passive."[36] Conceptually, a trader is someone who aims for rapid portfolio turnover, whereas an investor is someone who tends to hold securities for a longer duration.[37]

The foreign blocker purchases and holds interests in the CMV and does not transfer the interests to any person. Similarly, the CMV purchases CLO notes with the intention of holding them to maturity (and not primarily for sale to other investors). Thus, the foreign blocker will not engage "frequent, continuous and regular" buying and selling of the CMV's interests, and the CMV will not engage "frequent, continuous and regular" buying and selling of CLO notes.

When qualifying as an originator under the European risk retention rules, the CMV will purchase loans on the secondary market and will sell the loans to the CLOs.

However, the CMV will earn little, if any, income or gain on these sales. Instead, substantially all of the CMV's income and gain will be attributable to its management activities and ownership of the risk retention notes. Although the regulations do not define "principal business," the term should not include a business that the CMV does not enter into for profit and with respect to which the CMV in fact does not earn any material gross or net profit relative to the CMV's other activities.[38]

Accordingly, neither the foreign blocker nor the CMV should be considered to be principally engaged in trading stocks and securities for its own account, and the "regular" return on the risk retention notes should not be ECI to the foreign blocker.

However, with appropriate planning, the after-tax return to third-party investors in respect of the risk retention notes held by the CMV should be the same as the return that they would have received in respect of the notes had they invested in the notes directly.

3. CLOs Treated as Partnerships

A substantial amount of a CLO's assets typically consists of loans issued by U.S. obligors. Accordingly, if a CLO is treated as a partnership for U.S. tax purposes, then a substantial amount of income allocated to the CMV with respect to the CLO's equity (*i.e.,* its most subordinated class of notes) is likely to consist of U.S.-source interest income.[39]

U.S.-source interest income is ECI if (1) the income is derived from assets used, or held for use, in the conduct of a trade or business in the United States (the "asset use test") or (2) the activities of the U.S. trade or business are a material factor in the realization of the income (the "business activities test").[40]

The asset use test ordinarily is satisfied if the relevant asset is (1) held for the principal purpose of promoting the present conduct of the trade or business in the United States, (2) acquired and held in the ordinary course of a U.S. trade or business (such as a receivable arising from that trade or business), or (3) otherwise held in a direct relationship to the trade or business conducted in the United States (giving principal consideration to whether the asset is needed in that trade or business).[41]

If a CMV failed to hold a CLO's risk retention notes in accordance with the risk retention rules, it could be subject to regulatory actions or proceedings. Accordingly, the IRS could argue that the risk retention notes are held for the principal purpose of promoting the conduct of the CMV's management business and/or are held in a direct relationship to the management business.[42] If this argument were successful, U.S.-source interest on the risk retention notes would satisfy the asset use test and would be ECI.[43] For this reason, CMVs typically ensure that the CLOs that they manage are all treated as foreign corporations for U.S. tax purposes.

C. Increased Return on Risk Retention Notes

As mentioned above, CLOs typically pay the increased return to the CMV under a side letter pursuant to which (1) the CLO contractually agrees to distribute on the subordinated notes that are risk retention notes (in addition to the amounts to which the notes are otherwise entitled under the indenture) an additional amount, based on a specified formula; (2) the collateral management fees are contractually reduced by the same amount; and (3) the parties agree to treat the additional amount as part of the investment return on the risk retention notes (and not as a share of the management fees). The additional amount is payable on the risk retention notes regardless of whether the management agreement is terminated, and regardless of whether the risk retention notes are held by the CMV or transferred to another person.

Because the CMV is economically entitled to an amount equal to the increased return regardless of whether it enters into the side letter, some tax advisors are concerned that the increased return may be characterized as a portion of U.S.-source management fees. In this event, the foreign blocker would have ECI on its allocation of the increased return.

However, the better view is that the increased return should be treated as an investment return on the subordinated notes.

First, the increased return is payable even if the CMV's management agreement is terminated and thus is not contingent upon the CMV's (or any other person's) performance of services. By contrast, the CMV's right to receive collateral management fees is contingent upon the CMV's continued performance of services.[44]

Second, the increased return is payable to the CMV only as long as the CMV bears significant entrepreneurial risk with respect to the CLO by holding the risk retention notes. By contrast, the CMV is entitled to receive collateral management fees regardless of whether the CMV bears entrepreneurial risk with respect to the CLO by holding the risk retention notes.[45]

Third, the increased return may be transferred only with the risk retention notes. By contrast, the CMV's right to receive management fees is fixed under the collateral management agreement and thus is not transferrable with the risk retention notes.[46]

Moreover, anchor investors in CLOs have historically negotiated to receive a better return on their investment than other investors. Such an increased return clearly is an investment return (and not a fee for services) to a foreign anchor investor that negotiates to receive the increased return directly from the CLO, does not provide any services to the CLO, has recourse only to the CLO (and not to the collateral manager) with respect to the increased return, and is entitled to receive the increased return regardless of whether the collateral manager continues to provide services to the CLO. Conceptually, the third-party investors in the CMV have simply adhered to the historical approach of negotiating for an increased return, and then have contributed their right to receive this increased return to the CMV to allow the CMV to comply with the risk retention rules.[47] As a policy matter, it would be inappropriate for this deemed contribution, in and of itself, to cause foreign anchor investors in the CMV to have ECI.

V. Use of the Delaware Blocker

As discussed above, to comply with the European risk retention rules, the CMV must qualify as an "originator" by acquiring 5–10% of each CLO's target loan portfolio (by face amount) at least 15 business days before the CLO's closing date and selling the loans to the CLO on the closing date.

U.S. tax advisors commonly understand the word "origination" to signify directly making loans to the public, which the IRS asserts constitutes a U.S. trade or business.[48] This is not what the word means in the context of the European risk retention rules and, in fact, CMVs and other collateral managers typically comply with U.S. tax guidelines that prohibit them from acquiring loans other than in the secondary market to that the CLOs they manage are not engaged in a U.S. trade or business.[49]

However, because the CMV acquires loans to enable the CLOs it manages to comply with the risk retention rules, any interest income that the CMV earns on the loans and any gain that it recognizes on the sale of the loans might be viewed as a fee for services income.[50] Because of this potential ECI risk, the income and gain is allocated exclusively to the series C interests, which are held by the Delaware blocker and other U.S. taxable investors.

VI. Closing Observations

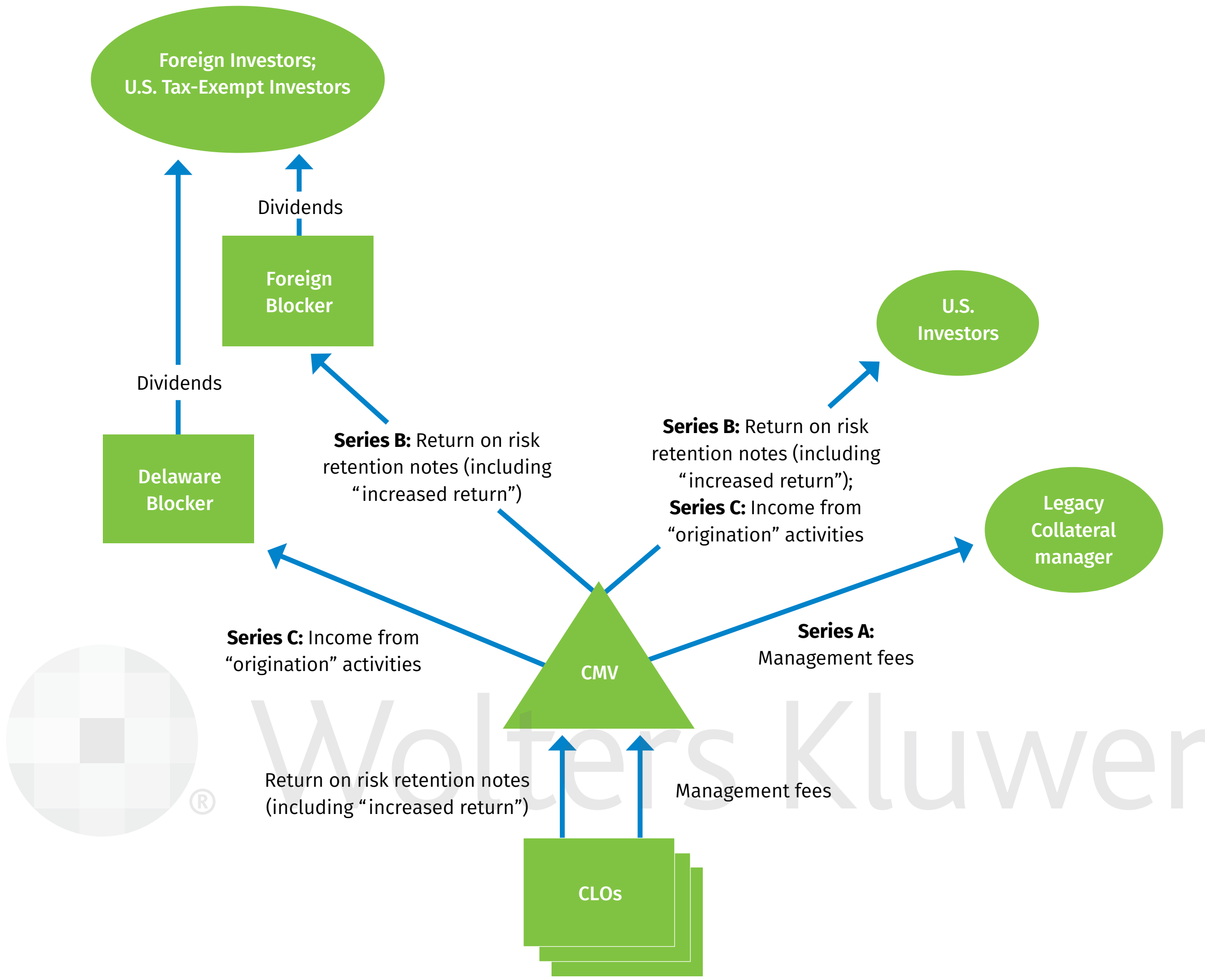
As mentioned above, on February 9, 2018, the U.S. Court of Appeals for the D.C. Circuit held that U.S. collateral managers of CLOs are not required to retain a financial interest in the CLOs under the U.S. risk retention rules. In its decision, the court noted that CLOs are not susceptible to the moral hazard inherent in the "originate to securitize" model that Dodd-Frank was intended to curtail.[51] Under the originate to securitize model, in the years leading up to the 2007–2008 global financial crisis, lenders allegedly originated loans using lax underwriting standards because they expected to be able to easily offload "toxic" credit risk to the capital markets by securitizing the loans.

Unlike the "static pool" securitizations with which Congress arguably was most concerned when it enacted Dodd-Frank, CLOs are actively managed, and their fee structure already aligns the interests of the collateral manager with those of the investors by providing for payment of the most significant management fees only after the CLO has paid off its debt and has achieved a specified internal rate of return on its equity. Because of this alignment of interests, a lender cannot easily offload toxic credit risk to a CLO.[52]

The CMV structure preserves this alignment of interests while satisfying the additional requirements that the risk retention rules impose. Legacy collateral managers typically do not have a robust balance sheet of their own and thus need capital from third parties to finance the acquisition of risk retention notes. It typically is not feasible for a legacy collateral manager to issue new equity directly to third-party investors. Using a CMV instead allows third-party investors to invest in a "clean" (*i.e.*, newly formed) entity and to provide the capital needed to acquire the risk retention notes.[53]

Because a CMV is treated as a partnership for U.S. tax purposes and is engaged in a U.S. trade or business, the CMV structure adds some complexity (and tax risk) for third-party investors. However, with appropriate planning, the after-tax return to third-party investors in respect of the risk retention notes held by the CMV should be the same as the return that they would have received in respect of the notes had they invested in the notes directly.

ANNEX 1.



ENDNOTES

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[1] *The Loan Syndications & Trading Ass'n v. SEC*, No. 17-05004, 2018 WL 798290 (D.C. Cir. Feb. 9, 2018).

[2] As discussed in Part IV.C., anchor investors in CLOs have historically negotiated to receive a better return on their investment than other investors.

[3] For a detailed discussion of the taxation of CLOs, *see* Jason Schwartz & David S. Miller, *Collateralized Loan Obligations*, 6585-1st Tax Mgmt. Port. (BNA) (2018).

[4] Management fees typically consist of (1) the "senior management fee," which is senior to payments on the CLO's notes and typically equals 0.15–0.20% annually of the face amount of the CLO's assets; (2) the "subordinated management fee," which is junior to payments on all but the CLO's most subordinated class of notes and typically equals 0.20%–0.35% annually of the face amount of the CLO's assets; and (3) the "incentive management fee," which is typically a 20% residual interest in the CLO's net profits that is payable *pari passu* with the CLO's most subordinated class of notes, but only after that class has achieved a specified internal rate of return (commonly 8–12%).

[5] CLOs managed by U.S. collateral managers typically are organized in the Cayman Islands.

[6] Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203), 124 Stat. 1376 (2010) [hereinafter "Dodd-Frank"].

[7] *Preamble* to Dodd-Frank. *Id.*

[8] One of the stated purposes of EU Risk Retention is "strengthening transparency, accountability and regulation." Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential re-

quirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, 2013 O.J. L 176/1.

9 As an alternative to the CMV structure, some collateral managers have set up an MOA that, itself, is the named collateral manager. (Practitioners sometimes refer to such collateral-manager MOAs as "C-MOAs.") The C-MOA can satisfy the European risk retention rules because it is the named collateral manager, is the retaining entity, and qualifies as an originator. For simplicity, the remainder of this article discusses CMVs. However, much of this discussion applies equally to C-MOAs.

10 In general, a manager who is not also an originator qualifies as a sponsor under the European risk retention rules only if it registers as an investment firm under, and is subject to the requirements of, the EU Markets in Financial Instruments Directive (Directive 2004/39/EC) (the "MiFID") and satisfies certain other requirements. U.S. collateral managers typically are not authorized as investment firms under the MiFID. We note, however, that the European risk retention rules have changed with effect from January 1, 2019. The changes will impose additional diligence and disclosure requirements on U.S. collateral managers but may permit U.S. collateral managers to be eligible to act as sponsors without acting as originators.

11 By contrast, a C-MOA is not regulated under U.S. law as a new collateral manager, and the personnel responsible for managing the CLOs can continue to be employed by the legacy collateral manager. The legacy collateral manager contributes at least 20% of the C-MOA's capital (*i.e.*, enough for the legacy collateral manager to establish a "controlling financial interest," within the meaning of generally accepted accounting principles), and third-party investors contribute the remainder.

12 For example, in many cases, it is desirable to establish one CMV with U.S. personnel to manage CLOs that are organized in the Cayman Islands, and another CMV with non-U.S. personnel to manage CLOs that are organized in Ireland, the Netherlands, or Luxembourg. Third-party investors may invest indirectly in each CMV through a single entity ("Topco"), which usually is organized in a low-tax jurisdiction such as the Cayman Islands or Jersey. Because Topco, each CLO, the foreign blocker described below, and potentially other entities in the structure are "passive foreign investment companies" for U.S. tax purposes, U.S. investors in Topco generally are subject to adverse tax consequences unless they make an election to treat each of these entities as a qualified electing fund (a "QEF") and to include in income their *pro rata* shares of each entity's income and gain each year. A QEF election is made by the first U.S. person (as determined for U.S. tax purposes) in a chain of ownership. *See* Reg. §1.1295-1(d)(1). Accordingly, for administrative ease, U.S. investors might invest in Topco through a U.S. feeder fund that is treated as a partnership for U.S. tax purposes and makes the QEF election with respect to each entity.

13 As discussed in Part IV.A., the CMV is engaged in a U.S. trade or business for U.S. tax purposes. Accordingly, U.S. tax-exempt investors generally will prefer to invest through the foreign blocker in order to avoid "unrelated business taxable income." *See* Code Sec. 511.

14 As a practical matter, the amount of the Delaware blocker's net taxable income and gain usually is immaterial relative to the CMV's other profits and may in fact be zero (*e.g.*, if the loans are sold at face value pursuant to a forward sale agreement that allocates 100% of any interest paid in between purchase and sale to the CLO).

15 For administrative reasons, it may make more sense to have foreign investors and U.S. tax-exempt investors invest into a foreign entity that, in turn, invests in the foreign blocker and the Delaware blocker. However, for the sake of simplicity, our paradigm structure does not include a "feeder" entity.

It should also be noted that, under this structure, tax-exempt investors economically bear corporate-level tax on their share of income from the Delaware blocker. With some additional structuring, it may be possible to avoid this result. However, because the amount of any such tax usually is immaterial relative to the CMV's profits, we do not discuss any such additional structuring.

16 Typically, this reduction comes from the subordinated management fees.

17 Alternatively, some CLOs issue "Class M Notes" to the CMV. The Class M Notes are economically identical to the additional amounts payable pursuant to the side letter described above but are issued pursuant to the CLO's indenture and described in its offering document. The tax disclosure in the offering document typically provides that the CLO intends to treat the Class M Notes as equity for U.S. tax purposes, and that purchasers of risk retention notes that receive Class M Notes on the closing date are required to allocate their purchase price among the subordinated notes (which also are treated as equity) and the Class M Notes based on relative fair market values for purposes of determining gain or loss upon a disposition.

18 Securities lawyers might insist that the CLO's offering document disclose this.

19 Code Sec. 864(b) (the performance of personal services within the United States is a U.S. trade or business).

As discussed in Part V, it is also possible that the CMV could be treated as engaged in a U.S. trade or business as a result of its purchase of loans and sale of those loans to the CLOs.

20 *See* Reg. §1.6012-2(g)(1) ("a foreign corporation which is engaged in trade or business in the United States at any time during the taxable year is required to file a return on Form 1120-F even though … it has no income which is effectively connected with the conduct of a trade or business in the United States").

21 Code Sec. 875(1) (a foreign partner in a partnership that is engaged in a trade or business in the United States is itself treated as engaged in a U.S. trade or business and is subject to U.S. federal net income tax on its allocable share of the partnership's taxable income that is "effectively connected" with that U.S. trade or business). In addition, a foreign partner generally is subject to U.S. federal net income tax on any gain that the foreign partner recognizes on a sale of its interest in the partnership to the extent that the foreign partner would have recognized ECI if, on the date of the sale, the partnership had sold all of its assets at fair market value. *See* Code Sec. 864(c)(8).

22 Code Sec. 882(a)(1) ("A foreign corporation engaged in trade or business within the United States during the taxable year shall be taxable as provided in Code Secs. 11, 55, 59A, or 1201(a) on its taxable income which is effectively connected with the conduct of a trade or business within the United States.").

23 Code Sec. 884(a). The resulting effective tax rate on ECI of a foreign corporation that is repatriated (or deemed to be repatriated) offshore is 44.70% (plus any state and local taxes).

24 Code Sec. 1446. Foreign partners in a partnership that is engaged in a U.S. trade or business are required to file U.S. tax returns and may apply the withholding tax as a credit against their income tax liabilities. *See* Code Sec. 875.

25 As noted above, all of the CMV's other profits—namely, its management fees and any interest income or gain with respect to loans acquired to qualify as an originator—are potentially ECI and are allocated to holders of the Series A and Series C interests (and away from the foreign blocker, which holds Series B interests). These allocations should be respected for U.S. tax purposes because (1) they are consistent with the parties' respective economic entitlements to distributions from the CMV, and (2) the parties' respective economic entitlements are reasonably expected to be substantially different from each other. *See* Reg. §1.704-1(b)(2)(iii)(a) (allocations are respected "if there is a reasonable possibility that [they] will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences," unless (1) they increase the after-tax economic consequences to at least one partner in present value terms and (2) there is a "strong likelihood" that no other partner's after-tax consequences will be "substantially diminished" in present value terms); *see also* Reg. §1.704-1(b)(5), Ex. (10) (allocation to a foreign partner of 90% of a partnership's net profits derived from operations within that partner's country of residence is respected where the amount of the allocation "cannot be predicted with any reasonable certainty"; by contrast, if all partnership items were to

be shared equally, but the foreign partner's share was "filled up" first with net income from operations within that partner's country of residence, then the "fill-up" allocation would not be respected because there is a "strong likelihood" that the partners' respective pre-tax economic entitlements "will be the same at the end of each partnership taxable year with such allocations as they would have been in the absence of such allocations").

[26] A few U.S. collateral managers and U.S. investors nevertheless prefer for a CLO to be treated as a partnership for U.S. tax purposes. Although there are risk retention structures that might accommodate this preference, a discussion of those structures is beyond the scope of this article.

[27] Generally, a foreign corporate CLO will be a CFC if more than 50% of its equity (*i.e.*, the subordinated notes) is directly, indirectly, or constructively owned by U.S. persons that each directly, indirectly, or constructively own 10% or more of the CLO's equity. *See* Code Secs. 957(a) (defining CFC), 951(b) (defining U.S. shareholder), and 958 (attribution rules). Otherwise, the CLO will be a PFIC. *See* Code Sec. 1297(a) (a foreign corporation generally is a PFIC if (i) 75% or more of its income in any taxable year consists of interest, dividends, and other "passive" income or (ii) 50% or more of its assets in any taxable year produce or are held for the production of "passive" income); Notice 88-22 (cash and cash equivalents are passive assets for this purpose).

[28] More specifically, if the CLO is a CFC and the CMV is a "United States shareholder" with respect to the CLO, then the CMV will be required to include, as ordinary income each year, its *pro rata* share of the CFC's subpart F income. *See* Code Sec. 951(a)(1); Reg. §1.951-1(a). All of a CLO's income and gain consists of subpart F income. *See* Code Sec. 952(a)(2) (subpart F income includes foreign base company income); Code Sec. 954(a)(1) (foreign base company income includes foreign personal holding company income); Code Sec. 954(c)(1) (foreign personal holding company income includes interest, capital gains from the disposition of property that gives rise to interest, and similar passive income); Code Sec. 954(b)(3)(B) (if a CFC's gross foreign base company income exceeds 70% of the CFC's gross income for the taxable year—as is the case for any foreign corporate CLO—then all of the CFC's income for the taxable year is treated as subpart F income). If, instead, the CLO is not a CFC, or the CMV is not a U.S. shareholder with respect to the CLO, then the CLO will be a PFIC. In this case, the CMV will make and maintain a timely election to treat the CLO as a QEF and, as such, to include in each taxable year (1) as ordinary income, the CMV's *pro rata* share of the CLO's ordinary earnings and (2) as long-term capital gain, the CMV's *pro rata* share of the CLO's net capital gain. Code Sec. 1293(a)(1).

[29] Code Sec. 1293(c) (QEF rules); Code Sec. 959 (CFC rules).

[30] *See Bank of America*, CtCls, 82-1 USTC ¶9415, 680 F2d 142, 147, 230 ClsCt 679 ("When an item of income is not classified within the confines of the statutory scheme nor by regulation, courts have sourced the item by comparison and analogy with classes of income specified within the statutes."); *see also* H. Rep. No. 586, 104th Cong., 2d Sess. 136 (1996) 1996-3 CB at 136, n. 14 (Subpart F inclusions generally treated as dividends that do not give rise to "unrelated business taxable income" to a tax-exempt entity); Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress*, JCS-12-96 at 215, n.159 (Dec. 18, 1996) (same).

[31] A CMV might also recognize gain on a sale of risk retention notes. As a practical matter, a CMV is intended to hold the risk retention notes until maturity. In any event, any such gain would not be ECI to the foreign blocker. *See* Code Sec. 865(a) (gain from a partnership's sale of personal property (such as risk retention notes) is sourced by reference to the residency of the selling partners); Code Sec. 864(c)(4)(A) (subject to limited exceptions, foreign-source gain is not ECI, even to a foreign person that is engaged in a U.S. trade or business (such as the foreign blocker)).

[32] *See* TAM 200811019 (Nov. 29, 2007); *cf.* Reg. §1.1446-2(b)(2)(ii) ("If a partnership receives a valid Form W-8ECI from a partner, the partner is deemed, for purposes of Code Sec. 1446, to have effectively connected income subject to withholding under Code Sec. 1446 to the extent of the items identified on the form.").

[33] Because neither the CMV nor the foreign blocker satisfies the activities test, it is unnecessary to address the nexus test.

[34] Reg. §1.864-4(c)(5)(i).

[35] *See* Reg. §1.864-5(b)(2)(iii) (a foreign holding company owning significant percentages of stocks and securities issued by other corporations generally would not be considered to be in the principal business of trading stock and securities for its own account even if it sporadically purchased and sold stocks or securities to adjust its portfolio).

[36] *Clearmeadow Investments, LLC*, FedCl, 2009-1 USTC ¶50,449, 87 FedCl 509; *see also, e.g.*, *R.P. Groetzinger*, SCt, 87-1 USTC ¶9191, 480 US 23, 107 SCt 980 ("[T]o be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity."). The distinction between trader and investor is often quantified by reference to the number of sales consummated in connection with the relevant activity. *See, e.g.*, *De Vegvar*, 28 TC 1055, Dec. 22,540 (1957), *acq.*, 1958-1 CB 4, *acq.*, 1958-2 CB 5 (between 35 and 199 purchases and between four and 257 sales of stock during each of seven years did not cause taxpayer to be engaged in a trade or business and subject to U.S. tax); *C.H. Liang*, 23 TC 1040, Dec. 20,917 (1955) (similar facts); *Continental Trading Inc.*, 16 TCM 724, Dec. 22,554(M), TC Memo. 1957-164, *aff'd*, CA-9, 59-1 USTC ¶9316, 265 F2d 40 (mere management of investment is not engaging in a trade or a business within the United States).

[37] *See J. Moller*, CA-FC, 83-2 USTC ¶9698, 721 F2d 810 (holding that a taxpayer whose holding periods for investments sold averaged three-and-a-half and eight years, respectively, was not a trader); *S.B. Levin*, CtCls, 79-1 USTC ¶9331, 597 F2d 760, 765, 220 CtCls 197 ("[A] 'trader' is an active investor in that he does not passively accumulate earnings."); *C.H. Liang*, 23 TC 1040, 1043, Dec. 20,917 (1955) (holding that investors purchase "for capital appreciation and income, usually without regard to short-term developments," while traders buy and sell "with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis").

[38] *Cf.* Rev. Proc. 2002-28, 2002-1 CB 815, Section 5.04 (a taxpayer's "principal business activity," for purposes of determining whether the taxpayer is eligible to use the cash receipts and disbursements method of accounting, is the business activity with the largest percentage of gross receipts using either a prior-year test or a three-year average test).

[39] A foreign partner is subject to tax on its allocable share of partnership income as if the income were realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership. Code Sec. 702(b); Reg. §1.702-1(b). Interest on a CLO's assets generally will be treated as U.S.-source if it is paid by (1) a U.S. corporation, (2) a U.S. branch of a foreign corporation or partnership, or (3) a U.S. partnership that is engaged in a U.S. trade or business at any time during the applicable tax year. Code Sec. 861(a)(1); Reg. §1.861-2(a)(1), (2).

[40] Code Sec. 864(c)(2); Reg. §1.864-4(c).

[41] Reg. §1.864-4(c)(2)(ii).

[42] Under Proposed Reg. §301.7701-3(a)(5), the entity classification of a "series" of a Delaware series LLC or a Delaware series LP generally would be determined at the series level, as long as the assets and liabilities of that series are segregated from the assets and liabilities of any other series. *See also* LTR 200803004 (the tax classification of a series LLC is determined independently for each series). Accordingly, it may be worth considering whether a CMV could take the position that, for U.S. tax purposes, Series A is a disregarded entity of the legacy collateral manager, Series B is a partnership among the foreign blocker and the U.S. investors (and the legacy collateral manager, if it contributes cash to the CMV), and Series C is a partnership among the Delaware blocker and the U.S. investors (and the legacy collateral manager, if it contributes cash to the CMV). However, segregating the assets and liabilities of Series C from those of Series A and Series B might put pressure on the risk retention analysis, so that, as a practical matter, it may be difficult to reach a high level of

comfort that each series should be respected as a separate entity for U.S. tax purposes.

[43] U.S.-source interest on the risk retention notes satisfies the business activities test only if the activities of the CMV's management business are a material factor in the realization of the interest income. Code Sec. 864(c)(2); Reg. §1.864-4(c)(1)(i). In applying the business activities test, "activities relating to the management of investment portfolios shall not be treated as activities of the trade or business conducted in the United States unless the maintenance of the investments constitutes the principal activity of that trade or business." Reg. §1.864-4(c)(3)(i). Even though the CMV's management of a CLO's investment portfolio may be a material factor in the realization of U.S.-source interest income on the portfolio, this interest income should not satisfy the business activities test because the principal activity of the CMV's trade or business is collateral management in exchange for management fees, and not the maintenance of investments.

[44] *Cf. Bank of America*, CtCls, 82-1 USTC ¶9415, 680 F2d 142, 230 ClsCt 679 (acceptance commissions were not fees for services because services "are not the predominant feature of the transactions"); *F.L. Merriam*, SCt, 1 USTC ¶84, 263 US 179, 188, 44 SCt 69 (1923) (payments treated as fees for services only if the payee "must perform the service to earn the compensation").

[45] *Cf.* Proposed Reg. §1.707-2(c) ("An arrangement that has significant entrepreneurial risk will generally not constitute a payment for services."); Preamble, REG-115452-14, 80 FR 43,652 (July 23, 2015) ("the proposed regulations generally reflect Congressional intent as to which arrangements are appropriately treated as disguised payments for services").

[46] *Cf. Hunt Foods & Industries, Inc.*, 57 TC 633, 642, Dec. 31,257 (1972) (convertible debt constituted a single security because the embedded debt and option features did not have physical and legal independence and could not be sold separately); Rev. Rul. 2003-97, 2003-2 CB 380 ("[W]hen financial instruments cannot be separately traded, the courts have generally treated them as a single instrument."); *citing, inter alia*, *Universal Castings Corp.*, 37 TC 107, Dec. 25,101 (1961) (corporation's notes and stock constituted a "single investment," because they were not separately tradable), *aff'd*, CA-7, 62-1 USTC ¶9499, 303 F2d 620.

[47] Indeed, the third-party investors typically negotiate for the increased return before the risk retention structure is established. This return may not be exactly the same as the return that the investors would have received if they had invested directly in the CLO's notes (*i.e.*, before the risk retention rules became effective). However, any such excess investment return arises solely because the investors are now "locked into" financing the acquisition of risk retention notes from a number of CLOs, whereas, before the risk retention rules became effective, investors typically negotiated their increased return on a case-by-case basis.

[48] *See* AM 2009-010.

[49] The concern that drives this prohibition is that the CMV could be viewed as the CLO's agent and, when the loans are transferred to the CLO, the CMV's lending activities could be imputed to the CLO, which could cause the CLO to have ECI.

[50] *Cf. Federal National Mortgage Ass'n*, 100 TC 541, 578, Dec. 49,102 (1993) (mortgages purchased in the secondary market were "notes receivable, acquired … for services rendered" within the meaning of Code Sec. 1221; service was providing "stability to the secondary market for home mortgages and liquidity for originating lenders"); *Burbank Liquidating Corp.*, 39 TC 999, 1010–1011, Dec. 26,025 (1963) (savings and loan association's business of making loans constituted a services business for purposes of Code Sec. 1221). In 2006, the IRS issued proposed regulations that would have changed the results in *Federal National Mortgage Ass'n* and *Burbank Liquidating Corp.* on the basis that "notes are not issued by borrowers solely or even predominantly for services rendered." REG-109367-06, 71 FR 44,600, 44,601 (Aug. 7, 2006). The IRS subsequently withdrew the proposed regulations and announced that it would "continue to study this area and may issue guidance in the future." REG-109367-06, 73 FR 21,861 (Apr. 23, 2008).

[51] *See The Loan Syndications & Trading Ass'n v. SEC*, 2018 WL 798290 at 6.

[52] Perhaps unsurprisingly, then, notes issued by CLOs have consistently outperformed comparable asset classes. Over the last 20 years, including during the 2007–2008 global financial crisis, CLOs suffered total credit losses of only 0.81%. LSTA, *Fact Sheet: CLOs and Risk Retention* (Feb. 24, 2016), *www.lsta.org/document/default/download/file/54a3ca7a-db03-11e5-af38-0050568e41f7*. Nevertheless, possibly because of similarities between their name and basic structure with collateralized debt obligation issuers ("CDOs"), which historically have invested in more complex assets and underperformed CLOs during the financial crisis, CLO notes have often been labeled as risky assets that contributed to the financial crisis. *See, e.g.*, Christopher Whittall, *Hunt for High Yield Fuels Boom in Another Complex, Risky Security*, WALL ST. J., Oct. 22, 2017 ("CLOs are often lumped together with other alphabet-soup acronyms of the financial crisis, such as more toxic CDOs, or collateralized debt obligations. But CLOs actually weathered the financial crisis well: Investors who bought at the top of the market in 2007 suffered paper losses, but there were no defaults at all for the highest rated securities.").

[53] In addition to relying on cash contributions from third-party investors, CMVs may borrow money to finance their purchase of some risk retention notes.