Tax Update

Application of New Debt-Equity Regulations to Securitizations

October 24, 2016

On October 13, 2016, Treasury and the IRS issued new final and temporary "anti-inversion" regulations under section 385 of the Internal Revenue Code that could treat certain purchasers of notes issued by securitizations as having exchanged their notes for stock in certain related domestic entities.

Unlike the proposed regulations issued in April, the new regulations do not apply to debt issued by foreign securitizations that are treated as corporations for U.S. tax purposes, such as most foreign CLOs.[1] The new regulations also do not apply to regular interests issued by a REMIC or, in general, to any debt issued by a commercial real estate CLO that is sponsored by a publicly traded REIT.[2] However, the new regulations do apply to U.S. securitizations other than REMICs, and to any foreign securitizations that are treated as partnerships or disregarded entities for U.S. tax purposes. Accordingly, the new regulations could affect many student loan securitizations, credit card receivables securitizations, and other "asset-backed" securitizations. The new regulations also could affect CLOs that are structured as partnerships or disregarded entities for U.S. tax purposes.

The new regulations are intended primarily to address the government's concern that multinational groups cause their U.S. subsidiaries to make deductible interest payments to foreign affiliates, effectively shifting earnings from the United States to foreign jurisdictions with lower corporate tax rates (*i.e.*, "earnings stripping"). However, the new regulations are drafted broadly and thus affect capital markets transactions (such as securitizations) in addition to multinational groups.

We discuss the new regulations at length in our general Tax Update. This memorandum focuses specifically on the effect of the new regulations on securitizations. Part I summarizes the application of the new regulations to securitizations, and Part II makes several observations regarding the impact of the new regulations on securitizations.

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1 The IRS has stated that future regulations will address debt issued by foreign corporations.

2 A commercial real estate CLO is treated for U.S. tax purposes as a disregarded entity or "qualified REIT subsidiary" of a REIT. The new regulations generally do not apply to debt issued by a REIT (including through a disregarded entity) unless the REIT is controlled through chains of 80% or greater ownership by one or more non-REIT corporations (which would not be the case for a publicly traded REIT). Moreover, although the new regulations do not explicitly address qualified REIT subsidiaries, these entities generally are treated for U.S. tax purposes in the same manner as disregarded entities.

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I. Summary

Most securitizations issue one or more classes of notes that are intended to be treated as debt for U.S. tax purposes, and one class of residual certificates that are intended to be treated as equity for U.S. tax purposes.[3] The securitizations often take the legal form of a limited liability company or statutory trust and are intended to be treated for U.S. tax purposes as a partnership, disregarded entity, or grantor trust.[4]

Although noteholders expect their notes to be treated as debt for U.S. tax purposes, the new regulations potentially treat a noteholder as having exchanged its notes for stock in a certificateholder[5] if:

- The certificateholder is a domestic corporation;
- The noteholder and certificateholder are members of the same "expanded group," generally meaning that they are directly, indirectly, or constructively connected through chains of 80% or greater ownership;
- The noteholder and certificateholder do not file a consolidated tax return; and
- For U.S. tax purposes, either—
    - The securitization is a partnership that is at least 80% owned (directly, indirectly, or constructively) by members of the expanded group,
    - The securitization is a disregarded entity, or
    - The securitization is a grantor trust.[6]

Thus, for example, if a foreign corporate parent purchases notes issued by a securitization that is treated as a partnership, and the corporate parent's two wholly owned domestic subsidiaries purchase 80% of the residual certificates in the aggregate, then the new regulations potentially treat the foreign corporate parent as exchanging its notes for additional stock in its subsidiaries.

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[3] CLOs typically use the term "subordinated notes" instead of "residual certificates." For convenience, we refer to the most junior class of instruments in any securitization as "residual certificates," and any other classes as "notes."

[4] Foreign CLOs instead take the legal form of a foreign entity, such as a Cayman Islands exempted company, and may elect to be treated as a disregarded entity or partnership for U.S. tax purposes.

[5] For this purpose, a certificateholder generally includes a domestic corporation that holds an indirect interest in residual certificates through one or more entities that are treated as partnerships, disregarded entities, or grantor trusts for U.S. tax purposes.

[6] Although the new regulations contain several exceptions, these exceptions are fact-dependent and may be difficult to apply with certainty to securitizations. In addition, as discussed in Part II, the treatment of grantor trusts under the new regulations is not entirely clear.

Any interest payments on the notes are treated as received by the subsidiaries (instead of the parent), and the subsidiaries are then treated as paying dividends to the parent in an amount equal to the interest payments. The dividends generally would not be deductible by the subsidiaries, and would be subject to U.S. withholding tax to the extent paid out of the subsidiaries' earnings and profits.

II. Observations

The new regulations raise several issues for securitizations:

- *Withholding tax.* If the new regulations apply to notes issued by a securitization, then the noteholder is treated as having exchanged its notes for stock in a related domestic certificateholder. If the noteholder is foreign, then, as described in the example above, the deemed dividends from the certificateholder are subject to U.S. withholding tax to the extent paid out of the certificateholder's earnings and profits.

  It is unclear who would be the "withholding agent" responsible for remitting this withholding tax to the IRS. If the trustee or other paying agents acting on behalf of the securitization are responsible for the withholding, then they will require the imposition of transfer restrictions on the notes to ensure that there is no withholding tax.

- *Non-fungibility*. Many securitizations are treated as disregarded entities of their sponsor for U.S. tax purposes, because the sponsor retains all of the residual certificates. If one or more classes of notes is not fully subscribed on the closing date, then an affiliate of the sponsor may acquire all or a portion of those classes with the intention of selling them at a later time. If the new regulations apply to these affiliate-retained notes (*i.e.*, because the affiliate is a member of the same expanded group as the sponsor, but does not file a consolidated tax return with the sponsor), then the affiliate will be treated as having exchanged the notes for stock in the sponsor. For U.S. tax purposes, this would cause the affiliate-retained notes to be treated as retired. When the affiliate later sells these notes to a third party, they would be deemed reissued, and may have to be retested to determine (1) whether they are treated as debt for U.S. tax purposes[7] and, if so, (2) the amount (if any) of their "original issue discount."[8]

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[7] Under the "funding rule" in the new regulations (which is most relevant to securitizations), if a noteholder was treated as having exchanged its notes for stock in a related domestic certificateholder, then the notes are treated as new "debt instruments" when they subsequently leave the expanded group. However, IRS personnel have informally cautioned that, if the deemed exchange caused the notes to be treated as retired as described above, then, notwithstanding the new regulations' characterization of deemed-reissued notes as "debt instruments," the notes would need to be retested upon their deemed reissuance to determine whether they are in fact treated as debt under general U.S. tax principles. Retesting would be consistent with the general rule that the debt-for-tax characterization of an instrument is tested at issuance. Moreover, the new regulations do explicitly require debt-for-tax retesting in other contexts.

[8] If the deemed reissuance is a "qualified reopening" under Treasury regulations section 1.1275-2(k), then the deemed reissued notes will be treated as having the same amount of original issue discount as the original notes. However, it will be

Debt-for-tax treatment for certain classes of notes is critical to many securitizations. If notes were required to be retested, and were found to be equity, they might be treated as equity in the securitization itself (rather than in a certificateholder), which could cause the securitization to become subject to entity-level tax and could give rise to additional adverse tax consequences for holders. In addition, even if the deemed-reissued notes were treated as debt for U.S. tax purposes, U.S. holders of the deemed-reissued notes could be subject to different tax consequences from U.S. holders of the "original" notes. If so, and if both the deemed-reissued notes and the original notes had the same CUSIP or other securities identifier, then the securitization might not be able to accurately report these different tax consequences to holders (*e.g.*, on Form 1099-OID).

- *Grantor trusts.* The new regulations do not explicitly address grantor trusts. However, because certificateholders in a grantor trust generally are treated for U.S. tax purposes as if they directly owned their share of the grantor trust's assets and liabilities, it appears that the new regulations could apply to notes issued by a grantor trust if any of the trust's residual certificates are owned by a domestic corporation belonging to the same expanded group as a noteholder. By contrast, the new regulations do not apply to notes issued by a partnership unless at least 80% of the residual certificates are directly, indirectly, or constructively owned by members of the expanded group. Thus, it may be easier for the new regulations to apply to a note issued by a grantor trust than to a note issued by a partnership.

  In many cases, the decision whether to treat a securitization as a grantor trust or as a partnership for U.S. tax purposes is largely elective. Grantor trust treatment has often been preferable, in part because many investors prefer receiving a Form 1099 from a grantor trust to receiving a Schedule K-1 from a partnership. Securitization sponsors and their advisors will now have to reassess the benefits and risks of grantor trust treatment in light of the new regulations.

In connection with a securitization, it is typical for the tax advisors to opine that notes issued by the securitization are debt for U.S. tax purposes. In light of the concerns summarized above, tax advisors could consider excluding from their opinions any notes that may be affected by the new regulations, such as notes held by a member of the same expanded group as a certificateholder. In addition, to the extent that the application of the new regulations could give rise to adverse tax consequences for the securitization or its investors, securitizations may impose new transfer restrictions on their notes to prohibit prospective investors from holding notes if they are members of the same expanded group as any certificateholders, unless the prospective investors and

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impossible to know, on the closing date for a securitization, whether a future sale of affiliate-retained notes will be a qualified reopening.

certificateholders file a consolidated tax return.[9] However, it may be difficult to enforce these transfer restrictions, particularly when the notes are held in book-entry form.

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If you have any questions about the foregoing, please contact any member of our Tax Group.

[9] These transfer restrictions also would apply to any affiliate-retained notes, as discussed above, unless the notes can later be sold under a different securities identifier from the original notes of the same class.