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New US Tax Rules Could Simplify Structuring of Future Inbound Investments and Securitizations

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Mayer Brown Legal Update

On September 15, 2017, the US Internal Revenue Service (IRS) proposed regulations to clarify and simplify the "registered form" requirement for debt obligations (the "Proposed Regulations"). The Proposed Regulations, if and when finalized, would expand the availability of the portfolio interest exemption from US federal withholding tax for interest paid to non-US persons by allowing the registered form debt requirement to be satisfied through a variety of entities and not only through a "grantor trust." As a result, the Proposed Regulations would eliminate the need for the use of many "grantor trust" structures that are currently implemented to facilitate inbound investments, including in securitizations with non-US equity investors. These new rules are expected to provide significant structuring flexibility in consumer finance asset (including residential mortgages, student loans, trade receivables and auto loans) acquisitions and securitizations.

Generally. Nonresident aliens and foreign corporations are exempt from US federal withholding tax on interest paid by US obligors to the extent that the interest is classified as portfolio interest (or an applicable income tax treaty provides an exemption). The portfolio interest exemption only applies to debt instruments that are in "registered form" and that satisfy certain other requirements. Many types of debt obligations are not typically in registered form, including residential mortgages and consumer loans. Therefore, in general, a non-US investor holding such debt obligations directly (or indirectly) would be subject to a 30-percent withholding tax on interest paid on such loans. However, 1984 temporary Treasury regulations (the "Temporary Regulations") provide that the registered form requirement is nevertheless met where a non-US investor owns a "pass-through certificate" in a grantor trust that is in registered form.

The Temporary Regulations are ambiguous as to whether interests in entities other than grantor trusts can be pass-through certificates. To date, many market participants that wish to transfer an equity (or junior note) investment in a pool of loans not clearly in registered form to a non-US investor will use a grantor trust as the securitization or pooling vehicle. The technical limitations of the grantor trust rules create structuring challenges to these arrangements because grantor trusts may not have the power to vary their investments or have more than one class of equity. Beginning in 2015, the IRS began issuing private rulings permitting interests in other entities to meet the registered form requirement. These private rulings, however, do not constitute general guidance.

The Proposed Regulations clarify that the definition of a pass-through certificate includes interests in a disregarded entity (such as a wholly owned LLC) or a partnership (but not corporations) that principally hold debt obligations. Based on the clarification, an ownership interest in a typical domestic pooling or securitization vehicle would generally be eligible to constitute a pass-through certificate for purposes of the portfolio interest exemption without regard to whether the vehicle has the power to vary its assets or whether there are multiple classes of ownership. This rule would provide investors the best of both worlds—the securitization vehicle can possess the power to add, modify and delete assets, and interest paid to the vehicle's non-US owners remains eligible for exemption from the 30-percent US federal withholding tax, regardless of whether the underlying loans are themselves in registered form.

Effective Date. The Proposed Regulations' expansion of the interests that would constitute a "pass-through certificate" only apply to pass-through certificates issued after the date that these rules are adopted as final regulations in the *Federal Register*. Proposed Regulations are subject to a 90-day comment period and a public hearing (if requested), after which Treasury and IRS engage in their internal process to determine when, whether and in what form to publish final regulations. Therefore, the enhanced flexibility to be offered by these rules is not yet effective. We have been informed by the IRS, however, that it will continue its existing practice of providing private letter rulings for specific transactions.

Other Considerations and Limitations. Importantly, the aspects of the Proposed Regulations described above only apply to the exemption of US federal withholding tax on interest paid by US obligors. Accordingly, the Foreign Account Tax Compliance Act (FATCA) rules must also be considered when non-US persons are paid such interest. Moreover, the flexibility provided by the Proposed Regulations to effectuate an inbound investment or securitization with a power to vary the

investments held by the pooling or issuing entity will not be unlimited. The ever-present concern as to whether the activities of the pooling or issuing entity will cause it to be engaged in a US trade or business must be monitored, particularly with respect to transactions that have a revolving asset base.

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